SMALL BUSINESS INVESTMENT COMPANY AND SPECIALIZED SMALL BUSINESS INVESTMENT COMPANY PROGRAMS

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

WASHINGTON, DC, OCTOBER 2, 1990

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SMALL BUSINESS INVESTMENT COMPANY AND SPECIALIZED SMALL BUSINESS COMPANY PROGRAMS

TUESDAY, OCTOBER 2, 1990

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room 2359-A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the committee) presiding.

Chairman LAFALCE. The Small Business Committee will come to order. This morning we are examining the investment company programs through which private companies, licensed by the Small Business Administration, provide venture capital to small businesses. These SBA licensees are called Small Business Investment Companies [SBIC's] unless they specialize in providing assistance to minorities, in which case they are called Minority Enterprise SBIC's or Specialized Small Business Investment Companies [SSBIC's].

The investment company program is authorized in the Small Business Investment Act of 1958, and for 25 years has been viewed as a shining example of public and private sector partnership.

During those years, the loss rate to the Government was almost nonexistent. In addition, if we take into account the additional taxes paid by firms assisted by the investment company program, it is clear that it is a real winner.

Success stories have abounded. There are SBIC stars such as Federal Express, Apple Computer, and Cray Research. There are MESBIC stars such as Essence Magazine.

More important, however, are the less than sensational businesses which have been started with the help of the investment company program, simply good, solid small businesses which create jobs and support our economy. These are the real success stories of the investment company program which has supplied capital of $9 billion.

However, beginning about 5 years ago, something happened, and the number of SBIC's began declining as licenses were being surrendered, and new applicants were not coming along to take their place. At the same time, requests for leverage or SBA money from the SBIC's also began declining.

Various reasons have been offered for this, and perhaps there is some validity to all of them. Some have argued that the 1986 Tax Reform Act reduced incentives for investments. Some have argued that the agency was guilty of overregulation. Some have argued

that it was uncertainty over the existence of the SBA. Others have argued that it was simply the economy and the stock market uncertainty.

Whatever the reason, this year three multimillion dollar SBIC losses have been announced. Almost overnight the program seemed to be going from a stellar performer which other countries wanted to replicate to one which some argue should never been founded. Some even cried that this was another savings and loan crisis and projected losses of $300 million, $400 million, or even $500 million.

In June, SBA responded by freezing new entries into the program. The Inspector General's staff fanned out to examine SBIC's. SBA personnel were shuffled. It now has been 3 months since these actions were initiated. I am pleased to note that disaster has not struck, and hopefully it will not.

Today, we have asked Administrator Engeleiter to appear before the committee, and the questions are many-fold. What happened? How did the agency respond to not only protect the Government's interest but also to help the program? What are the latest steps the agency has taken in proposed rules published late last week and why? Are there further administration actions to be taken?

I want to note my personal concern about the direction of this program, and also with some of the doomsday stories which have been told. But I do not believe that this venture capital program is doing as poorly as some suggest. It may be that it can be improved as is true of almost any program. It may need legislation. If so, I am prepared to consider it at the earliest possible date, and I look forward to the Administrator's input on this.

I have every confidence that the Administrator will tell us all of this and more. Then we will turn to the industry representatives who are here today to present their views. Mr. Walter Wilkinson, chairman of the National Association of Small Business Investment Companies; and Mr. Walter L. Threadgill, legislative chairman of the National Association of Investment Companies.

[Mr. LaFalce's statement may be found in the appendix.]

Chairman LAFALCE. The ranking minority member Congressman McDade, and a member of the minority Mr. Conte have prepared statements. They have asked me if there is no objection to put them in the record. Without objection, so ordered.

[Mr. McDade's and Mr. Conte's statement may be found in the appendix.]

Chairman LAFALCE. Does anyone else wish to make a statement?

Mr. BILBRAY. Mr. Chairman.

Chairman LAFALCE. Mr. Bilbray.

Mr. BILBRAY. Mr. Chairman, I have a statement that I would like to submit for the record. But I would also like to state that I have to leave at 10:30. It is not because of lack of interest in the subject. But I am a member of the Armed Services Committee conference committee, and it is our first meeting. But I am leaving a very competent member of my staff to take notes, because I believe that this is a very important area.

Certainly, we want to see this area to continue to function as it has in the past, and certainly not be plagued with the kind of problems that other financial programs have had. So I am very interested in hearing the testimony of Ms. Engeleiter. Thank you.

[Mr. Bilbray's statement may be found in the appendix.]

Chairman LAFALCE. Ms. Engeleiter, the floor is yours. Could you also please introduce your associates from the SBA.

TESTIMONY OF SUSAN ENGELEITER, ADMINISTRATOR, U.S. SMALL BUSINESS ADMINISTRATION, ACCOMPANIED BY MITCHELL F. CRUSTO, ASSOCIATE DEPUTY ADMINISTRATOR FOR FINANCE, INVESTMENT, AND PROCUREMENT, SALLY NAREY, GENERAL COUNSEL, AND JOSEPH L. NEWELL, DIRECTOR, OFFICE OF INVESTMENT

Ms. ENGELEITER. I certainly will, Mr. Chairman. Mr. Chairman and members of the committee, it is a pleasure to testify before you today as Administrator of the United States Small Business Administration. I am accompanied today by Mitchell Crusto, who is the Associate Deputy Administrator for Finance, Investment and Procurement. Mitch is to my left. Ms. Sally Narey, who is our General Counsel. Mr. Joseph L. Newell, who is the Director of our Office of Investment.

You have asked me today, Mr. Chairman, to address the Small Business Investment Company program. It has been a number of years since either oversight committee or previous SBA Administrators have thoroughly reviewed the program. I appreciate the attention that you and the committee are giving to its improvement. I do consider us to be allies in correcting the problems that have developed in the program.

Clearly, the SBIC program was created with the very best of intentions in the 1950's. Its mission is to help America's small businesses obtain the start-up and growth capital that they usually cannot obtain from banks and other financial institutions. SBIC's are fulfilling that mission and the need for the program does remain very strong. Since the 1950's, the program has contributed more than $9 billion to America's small businesses.

Unfortunately, however, the program has had a number of problems, some of which stem from the inherent risks involved in investing in small businesses. I believe that it is very important for Congress to determine what level of risk it is prepared to accept in order to achieve the program's mission.

Problems have also resulted from the financial structure of the program, which encourages thinly capitalized SBIC's to leverage up by borrowing Government funds to make equity investments in small businesses. Equity investments like other types of stock investments seldom offer immediate cash flow for the SBIC's. This can result in an eventual cash flow crunch when the SBIC's attempt to repay loans and meet operating expenses.

The cash flow need may ultimately conflict with pure equity financing of small businesses. At the same time, inadequate Government oversight and supervision of the SBIC program led to ineffective monitoring and regulation of the industry. This was due in part to cut backs in staffing going back many years, and in part to a longstanding separation of program functions. No one office at the Small Business Administration has had full oversight responsibility over the program.

In my written testimony, Mr. Chairman and members, I have described how these programs came to my attention last year and the steps that I have taken to investigate and remedy them. I would like, however, to summarize our findings and the actions that we have taken.

As a result of our review of program operations, it has become clear that there was no clear picture of the financial status of the industry, that SBIC oversight was unnecessarily split between agency units, program regulations did not effectively prevent abuses and deviations from the basic purpose of the program, that there was insufficient staff for necessary oversight, and there was undue risk of loss to the Government without sufficient financial safeguards.

We are not strengthening program oversight and internal controls, reevaluating our regulatory policies, and assessing our staffing needs. Let me describe what we have done.

First, we have made several management changes in the program. We have installed as Associate Administrator for Investment one of our most seasoned career professionals, Mr. Bernard Kulik. Mr. Kulik is on a much earned and long planned vacation, Mr. Chairman and members, out of the country. Otherwise, Mr. Kulik would be with us today. We have also identified the need for additional staffing.

Chairman LAFALCE. Ms. Engeleiter, how permanent is that since Bernie has been sent from one program to another program to another program?

Ms. ENGELEITER. Mr. Kulik has made a commitment to me, Mr. Chairman, that he will be in this position as long as is necessary to solve the problems.

We have also identified the need for additional staffing and have added five new positions to our investment division. In addition, we are conducting a review to determine a level of resources and staffing sufficient to cover improved analysis and oversight, on site reviews, and more thorough evaluation reviews.

Second, we imposed a 90-day moratorium on issuing new SBIC licenses which expired on September 29, 1990. This moratorium enabled us to review the management and operation of the program including licensing requirements and to initiate appropriate changes. The review of licensing requirements was done with the help of the private sector council. New licensing requirements were published in the Federal Register.

Third, we have proposed a number of regulatory changes which have been published for comment. One change would adopt Government accounting standards for SBIC audits by independent public accountants, as recommended by the General Accounting Office. As a result, we will obtain additional separate reports from the SBIC's independent public accounting covering the SBIC's internal controls and regulatory compliance. This should materially assist our oversight role.

A second regulatory change contains 15 proposed revisions covering areas such as limitations on Government debt subordination, requirements for financial statements from small business owners, limitations on leveraged buyouts, and limitations on the placement of idle funds.

A third change would clarify the portfolio review requirements for independent public accountants. This is not intended to make the accountant an appraiser or to substitute the opinion of the accountant for that of the SBIC. It is intended as a routine check on the operation of the SBIC by its independent outside auditor.

Other changes under consideration include revision of the size standards, development of a policy on the effect of delinquent preferred stock dividends on SBIC, leverage requests, and definitions of social or economic disadvantage for specialized SBIC's.

Fourth, as required by statute, we have just completed a SBIC funding in which we requested that SBIC's provide additional information for portfolio evaluation. For this funding, SBIC has requested $77 million in additional funding. After a careful review of the financial material filed in support of these requests, SBA scrubbed the funding request to $17.46 million.

Let me make it clear that the agency has not changed its criteria for the guarantee of debentures. We are reviewing each request individually and making funding determinations based on all of the appropriate credit factors involved. All SBIC's including specialized SBIC's are subject to the same reasonable credit analysis.

Fifth, with respect to valuation problems, the Inspector General has completed phase I of his special study of SBIC valuations, and has reported the findings of his study. We have reviewed the draft report which details the valuation practices and problems of five SBIC's.

One appears to have no portfolio valuation programs. A second will be carefully watched because of its financial weaknesses and that of its parent bank. A third which has some questionable valuations but is not capitally impaired has been asked to supply specific valuation information. A fourth has been ordered to cure its probable impairment or face liquidation. The fifth is being considered for liquidation based in part on evidence from the Inspector General's report.

Sixth, phase II of the Inspector General's study which involved on-site examinations of certain SBIC's has been completed, and we would expect to receive the report very shortly. Appropriate action will be taken.

Seventh, at the request of the investment division, an outside contractor has completed an evaluation study of a related group of SBIC's. This study has raised certain questions which are being pursued with the SBIC's.

Eighth, for those SBIC's not covered by these on site visits, the investment division required from each SBIC that they provide a one time financial and regulatory analysis disclosure statement which has given us current details of the status of each SBIC, its portfolio, and its accounting practices as of June 30, 1990. These reports are being evaluated.

In addition, the Inspector General is concentrating on the responsibilities of the SBIC's independent public accountants. An expert in audit quality control has recently joined the Inspector General's staff, and appropriate action will be taken and will be forthcoming.

We feel that reviews of the portfolio valuation of SBIC's would be very valuable in protecting the more than $1 billion investment

that the Government has outstanding in the SBIC program. We are contemplating a major study of the value of the portfolios of all SBIC's with Federal leverage. With that step, we will be able to get a better estimate of the financial health of the SBIC's.

Our basic purpose, Mr. Chairman and members, in taking these steps is to enhance the success of this program. Our goals are to improve the agency's ability to detect problems early, to develop solutions in a timely manner, and substantially improve the efficiency of operating procedures.

Let me now turn to the SBIC's which we have reviewed and summarize our findings. First, we found that the backlog of SBIC cases in liquidation had grown to over 170 owing the Government over $500 million. We found that there were only five staff members managing these cases, and that there were substantial amounts of idle cash in a number of SBIC's in liquidation.

There were insufficient controls in place to handle the liquidations. Senior management was not involved in liquidation decisions involving millions of dollars. When SBIC's were transferred to liquidation, their assets were valued according to value set by SBIC management rather than attempting to determine their true current value for the purpose of assessing potential recovery or booking current loss.

We also found staffing levels in the SBIC liquidation and portfolio management section over the last decade to be woefully inadequate. Due to budget constraints, staffing in this area failed to keep pace with increased activity both in terms of numbers and in terms of the complexity of the cases.

From 1980 to 1989, SBA averaged two to three full time employees in SBIC liquidation staff with additional assistance from six outside contractors on receivership cases. In 1980, the liquidation portfolio was at $86 million. But by 1989, it had grown to almost $500 million. Despite this growth, there were only five full-time employees in 1989.

Recognizing this problem, I submitted a request for additional staffing to the Office of Management and Budget. As a result, seven new full time employees will be added to this function, five are already working. Even so, industry standards are $10 million per portfolio liquidator. If this standard were applied to our $500 million portfolio, we would need additional staff to supplement those already working in the program as well as staff from the Office of General Counsel who are assisting us, and the contract receivership agents who are helping as well.

In addition, many of the salaries offered for comparable financial and specialist positions at other agencies such as the RTC or the FDIC are at least one grade higher than those are the Small Business Administrator. Some of our analysis indicates some of our employees would receive a 20 percent increase for similar work at FDIC. Obviously, this makes retention and recruitment very difficult.

Nevertheless, we believe that we are continuing to make a great deal of progress despite an overworked staff. As you know, there has been an upturn in SBIC defaults since 1985. The average number of SBIC's annually placed in liquidation is doubled from 13 to 26 over the past 5 years. Perhaps even more disturbing, howev-

er, are the size and complexity of those SBIC's going into liquidation. In fact, the two largest liquidations in the history of the program occurred in the last year.

There are many factors that may have caused this trend including the repeal in 1986 of the income tax exclusion on capital gains, the bursting of the high technology investment bubble of the late 1970's and early 1980's, the 1987 stock market collapse which depressed stock prices and seriously limited opportunities for taking young start-up companies public at favorable stock prices, and also greater competition from other capital sources for fewer good deals with sufficiently high returns.

In order to better manage the liquidation process, we have taken the following actions. We have recovered over $25 million, closed out 28 SBIC liquidation cases, and written off $30 million as uncollectible. As many as 20 additional cases totaling $76 million are targeted for resolution by the end of the year. We have identified cases in which SBIC's in receiverships have excess cash in their accounts, and have moved where appropriate to have the excess cash transferred to the SBA.

We are actively pursuing these claims through the courts, and in one case alone have collected over $1 million in cash. We have completed liquidation plans for five SBIC's that have not complied with existing settlement agreements. We have implemented revised procedures to independently value the assets of SBIC's that are in liquidation and the assets acquired from failed SBIC's that voluntarily assign their assets to SBA.

We have revised internal accounting procedures to ensure that losses anticipated in liquidation proceedings are recognized immediately upon transfer to the SBA. We have established new procedures to involve senior management in the liquidation process, and have strengthened the guidelines for approval of expenditures relating to the liquidation of acquired assets. We have developed and begun implementing new operating procedures for SBIC's in receivership.

We have also restructured the office of SBIC liquidation. We have updated our liquidation procedures manual with the final draft scheduled for the end of this calendar year.

In summary, Mr. Chairman and members of the committee, the purpose of all of these actions taken thus far is to make the SBIC program more effective and more efficient while continuing active Government encouragement of venture capital for small businesses.

We believe that these remedial steps will limit the agency's vulnerability to financial losses and provide more efficient and timely identification and resolution of problems in the program.

Mr. Chairman, I want to thank you and the other members of this committee for your strong interest in the health of the SBIC program as we continue to take necessary steps to correct program deficiencies, some of which may necessitate legislative changes, and I look forward to your continued support. Working together, I believe that we will be able to protect the Government's interest while ensuring that SBIC's remain a valuable source of capital for American small businesses. Thank you very much. We would be glad to entertain questions.

[Ms. Engeleiter's statement may be found in the appendix.]

Chairman LAFALCE. Thank you, Ms. Engeleiter. A number of members have told me that they have some time constraints because of conference committees. I wonder if Mr. Skelton or Mr. Bilbray have any questions before they leave. No; all right. Thank you.

Ms. Engeleiter, what is the bottom line, what losses have we experienced and what losses do we anticipate experiencing, what is the net cost going to be to the taxpayer?

Ms. ENGELEITER. To give you a broad outline and to put the potential losses in perspective, let me say again that since this program was started that the combined public and private contribution to the SBIC initiatives has been $9 billion. Roughly $3 billion of that has been the Government's contribution. The amount of SBIC assets that were in liquidation when we began this process was roughly $500 million. I would ask our general counsel if she would like to add to exactly what the current status is in terms of collection and how much of that we will be writing off.

Ms. NAREY. Thank you, Mr. Chairman. I think that Joe and Mitch can probably help in terms of some of the numbers. There has been an upturn in the number of SBIC's that have gone into liquidation. Currently I think that we are looking at a total of about $500 million, of which about $66 million I think had been collected, leaving approximately $400 million of which we are trying to make a recovery.

Now that will take some time to actually realize the recovery. But historically, the recovery has been between 40 and 60 percent of those amounts that are in default. So we anticipate that the total that we are looking at is probably somewhere around perhaps $200 million at the worst.

Mr. NEWELL. According to the figures that I have, the ultimate losses we are expecting will approach $375 million.

Chairman LAFALCE. How do we get to $375 million? If we have $66 million out of $500 million, it leaves about $430-some million. If we have a 40 to 60 percent rate or let us say 50, that would be about $200 million. According to Ms. Narey's calculations, it is around $200 million. How you are saying about $375 million.

Mr. CRUSTO. Mr. Chairman, let me describe the process. There is outstanding approximately $1.2 billion of Government assistance. In the form of guarantee authority it is approximately $800 million. In preferred stock, direct purchases of preferred stock of the balance. The guarantee authority of course comes by way of debenture sale. The Government does not incur any losses until those debentures are defaulted, at which time the Government pays the debenture holders.

At this point in time, we have approximately $500 million that has been paid to debenture holders. At that point in time, that $500 million goes into the liquidation category, and then we make attempts to collect against that payment. At that point in time, once again the Government has already paid its obligation and then we collect against that amount.

Historically, our collection rate has been about 64 percent. So based on that calculation, anywhere from $200 million to $350 million may be the loss rate on that outstanding balance.

Chairman LAFALCE. What is your outstanding balance?

Mr. CRUSTO. The outstanding balance is approximately $500 million that has been in liquidation. We have already paid the debenture holders on that amount. We now have to collect against that amount.

Chairman LAFALCE. But you said that you usually collect around 60-some percent?

Mr. CRUSTO. Approximately 64 percent. But we have experienced in a couple of years and more recently with some of the larger SBIC's going under calculations that may bring it closer to 50 percent in our collection efforts. That is a collection effort that goes on over a period of years, so it is hard to give you an accurate figures.

Chairman LAFALCE. I am still a little confused. Because, you know, we are tossing out these figures. But if it is $500 million and it is 50 percent, that is $250 million. Mr. Newell said $375 million.

Mr. CRUSTO. Once again, it depends. The historic experience that we have had in collection has been 64 percent.

Chairman LAFALCE. That is recovery?

Mr. CRUSTO. Recovery, yes, sir.

Chairman LAFALCE. OK. But assuming that it is 50 percent.

Mr. CRUSTO. Right; it would be $250 million.

Chairman LAFALCE. $250 million. Mr. Newell, how did you come up with your $375 million? I mean we are talking rather big dollars. I just want to know how you arrive at it.

Mr. CRUSTO. I think that Mr. Newell's figures anticipate more SBIC's going into liquidation, this is not a stagnant situation.

Chairman LAFALCE. Let me ask Mr. Newell.

Mr. NEWELL. That is correct. The rate that I am speaking about and the figures that I am speaking about are figures which are not only based on companies that are currently in liquidation but based on a projection of companies that are predicted to go into liquidation and relative to those.

Chairman LAFALCE. So $500 million is in liquidation presently.

Ms. ENGELEITER. $500 million has been paid.

Chairman LAFALCE. Has been paid.

Ms. ENGELEITER. Has been paid.

Chairman LAFALCE. All right, has been paid. What are your projections and over what period of time?

Mr. NEWELL. The projections that I have were developed by our liquidation section, and there are people present here from that section who might better be able to explain how the figures were developed.

Chairman LAFALCE. Fine; I just want to understand. People are tossing out figures. What they stand for and how they are arrived at.

Ms. NAREY. Mr. Chairman, if I might jump in here. I think that one of the things that has been experienced in the recent few months or years has been an increase in the number of SBIC's that have gone into liquidation. That number really doubling on an annual basis from I think 13 to 26 over the course of the last several years.

Another factor that has happened in arriving at these calculations is looking at the size of the SBIC's that have gone into liqui-

dation, which have as you know increased dramatically, with the three largest SBIC's ever.

Chairman LAFALCE. I understand that, Ms. Narey.

Ms. NAREY. But one of the things that has happened is as the economy in the Northeast and real estate prices have dropped that a number of SBIC's, the large SBIC's——

Chairman LAFALCE. I understand that assumptions are going to change the figures that you arrive at. But once you give me a figure, all I want to know is what assumptions did you use. So I have been given a figure of $375 million. All I am asking for is what are the assumptions that you use, what are the assumptions about additional liquidations, what are the time periods. They are simple questions. There are no curve balls here.

Mr. CRUSTO. The question is directly placed. But the calculation is not simple, and that is the nature of the problem. We could certainly provide that in writing to you, Mr. Chairman. Joe Newell's presentation basically is a reflection based on our experience on repayment of SBIC's and then the residual that may go into liquidation, and the ultimate loss rate would be to the entire program.

At the present time, the figure that we have is that $500 million is in liquidation. Our collection experience has been 64 percent. It could be worse than 64 percent based on new figures coming in.

Chairman LAFALCE. I know that, but we are rehashing ground.

Ms. ENGELEITER. Mr. Chairman, we have a member of our liquidation staff who will be glad to elaborate.

Mr. CIBOLSKI. Actually the response here is that this projection is showing a little more pessimistic recovery projection; probably closer to 40 percent.

Chairman LAFALCE. First of all, what is your name, sir?

Mr. CIBOLSKI. Ron Cibolski.

Chairman LAFALCE. Ron Cibolski. So, you are projecting a 40 percent recovery rate?

Mr. CIBOLSKI. On some of these larger liquidations.

Chairman LAFALCE. Larger; but what is the time frame for which we are making this projection that resulted in a $375 million loss?

Mr. CIBOLSKI. We are probably looking at a recovery here over the next 5 years.

Chairman LAFALCE. I hate when we say probably when we have a figure. Because when we have a figure, that means we are not talking about probably. We are talking about the calculations that were used.

What is the additional amount of dollars that we expect to be paid out over that period of time against which you applied your 40 percent?

Mr. CIBOLSKI. I am basing that on the present cases in liquidation. Renewal has——

Chairman LAFALCE. Then this differs from what I was just told.

Mr. CIBOLSKI. There have been some——

Chairman LAFALCE. Does it not? I was told that this dealt not only with cases presently in liquidation.

Mr. CIBOLSKI. Present and presently coming into liquidation.

Chairman LAFALCE. I mean, they are either in or they are out. Are these numbers referring to those that are in or those that might come in in the future?

Mr. CIBOLSKI. Mr. Newell has some. I am sure that we are looking at based on a study that has just been done, there are additional cases coming in in the next months.

Chairman LAFALCE. All right; I am very dissatisfied with the response. I am just trying to find out what is going on, what you expect is going to be going on, and it is obvious that we need SBA to huddle on this issue and give us better information.

Ms. ENGELEITER. Mr. Chairman, we would be glad to give you a very detailed response in terms of all of the assumptions that we have made and what our best projection is.

Chairman LAFALCE. I was really hoping that we would have that at the time of the hearing since the hearing is focused on the SBIC situation.

Ms. ENGELEITER. Mr. Chairman, it is very difficult to project what we are going to recover. Some of the receiverships——

Chairman LAFALCE. I understand that.

Ms. ENGELEITER. That agency is dealing with——

Chairman LAFALCE. The projection has been made, and I simply wanted to know what the assumptions were in making that.

Ms. ENGELEITER. We would be glad to provide that for you, and I think it is important to remember, Mr. Chairman, some of the receiverships we have been dealing with are 20 years old. As our general counsel has indicated, there has been a dramatic upturn in the number of SBIC's that are failing and it is very difficult to project exactly how much we are going to recover. But we will provide you the information.

Ms. NAREY. If I could just add one thing, Mr. Chairman, in correlation with what the Administrator has just said.

These recent SBIC's that have gone into liquidation, the ones that are particularly large, the largest ones in the history of the program contain large portfolios of real estate, some of which are going to be difficult to make much of a recovery on, some of which may not. A lot is going to depend on what happens to the real estate market generally in the northeast. That is one factor.

The other factor is having just completed some of the studies that have been done, it has become apparent that some of the SBIC's may be in trouble that were not perceived to be in trouble in the past. I think one of the things that the Office of Portfolio Management is doing is trying to grapple with at what point they are in a troubled situation and may eventually require a Government payment of their debentures, and at which point they may not, and trying to factor all that into making the assumptions.

You indicated that we were talking about numbers. While there are numbers here, they are projected numbers, and those are, of course, always subject to change in any business when you are trying to deal with numbers.

Chairman LAFALCE. Look, I had Ed Gray before me. I had Danny Wall before me. I had Treasury before me. I tried to pin them down on numbers, and I was very unsuccessful. They were just guessing. If you are guessing, that is fine, but I want to know what the basis of your guess is. I want to know the methodology, because

I subsequently discovered that the Federal Home Loan Bank Board was just picking figures out of the air.

I do not mean to make any comparison in scope between this problem and the S&L problem. For those who do, they are probably sending out alarms that might be more harmful than helpful. On the other hand, there are striking similarities in kind if not in degree. You mentioned because of the difficulties in valuing real estate that are contained in portions of a portfolio, very difficult, very difficult. Are you marking to market, or is it your original cost, or was it your highest estimate at the peak of the real estate?

Mr. CRUSTO. Mr. Chairman, even more difficult is, quite frankly, the inherent nature of the investments in small business which is really what this program is all about. We are fortunate when we have real estate. More often than not, as this program was designed, the SBIC's are making equity investments in small business which, quite frankly, have no market value.

Chairman LAFALCE. Yes.

Mr. CRUSTO. So that is why it is very difficult for us to give you a concrete figure. We can give you a figure based on estimates, based on our historic collection rate. But oftentimes when an SBIC goes into liquidation, we are holding nothing. We are holding equity investments in small businesses.

Chairman LAFALCE. There is another striking similarity and disturbing similarity. For years we said the basic problem in the thrift industry was the desupervision that took place, the lack of supervisors, the reduction in the number of supervisors, the inadequate salaries paid to the too few supervisors. Of course, one of the problems we have had over the years has been over the SBA budget. We have always wanted to have more supervisors. Under the OMB strictures, those supervisors and those examiners have been emasculated in number, and you just cannot afford to have inadequate examination which, obviously, is a judgment that you have made because you are now requesting more. I do not want to say it is too late, but I think perhaps considerable damage has been done by the inadequacy of the number of examiners and the quality of examination.

Ms. ENGELEITER. Mr. Chairman, speaking for this administration, the Office of Management and Budget has been very cooperative after we identified this problem last year, and has been very responsive in terms of providing needed positions.

If you are familiar with our budget, Mr. Chairman, as you are, you know that we have a sizable increase in staffing generally in the agency. So, this Office of Management and Budget has been very cooperative.

Ms. NAREY. Yes; right. Mr. Chairman, can I add one more thing going back to your earlier question about the—not to digress back. You were interested in the projections, and I have been provided just a sheet of the lost projects.

The total portfolio in liquidation right now, not where the Government has paid out yet, but the total amount that is in liquidation status only is about $1.2 billion. An estimated default rate has been applied of 28.5 percent, and I am not the person to tell you how they came up with the 28.5 percent.

Chairman LAFALCE. Sure.

Ms. NAREY. But we would be happy to provide you with that later. Leaving a gross loans estimated to default of $347 million, roughly. Using an estimated loss rate of about 40 percent, coming up with the total projected losses there of $134 million. Then adding that in with the actual net losses and allowance for losses currently in liquidation, and that comes up with the total of $375 million. We would be happy to sit down later with you and talk about where those assumptions come from, or the 28.5 percent there.

Chairman LAFALCE. Give me a detailed accounting of that in writing. Then after we have had an opportunity to review that detailed accounting, then we will sit down on that issue.

Ms. NAREY. OK. Hopefully that will clarify it for you.

Chairman LAFALCE. Good; let me just ask one more question before I give it over to the other members. This Sunday an announcement was made regarding a budget agreement. Included in the budget agreement are certain types of tax benefits for small businesses. Now, some people are saying this is tremendous, and other people are saying that this is going to revive the worst abuses of the tax shelter concept and programs. I am just wondering how this might impact either investments in SBIC's or investments by SBIC's. It may be premature to ask you for any definitive statement on that, but have you looked at that at all?

Ms. ENGELEITER. Mr. Chairman, I have not looked in a lot of detail at that proposal and the impact it would have on the SBIC industry. I would be glad to do that, and provide that to you in writing today even if I can get enough details in terms of the proposal.

Chairman LAFALCE. Yes; please do so.

Ms. ENGELEITER. Clearly, Mr. Chairman, we are finding in our dialogue with business owners around the country that there certainly is a lack of capital and a credit problem, both with debt financing and equity financing in this country. Whatever can be done to have more capital available for small businesses certainly would be helpful. But I am not familiar with the details. As I mentioned in my testimony, Mr. Chairman, one of the reasons that we feel that there has been less funds, less investors interested in SBIC's and SSBIC's is the change in the capital gains tax law in 1986. So, clearly, more capital is needed, and we would be glad to look at the proposal and give you a specific answer.

Chairman LAFALCE. Thank you.

Mrs. Meyers.

Mrs. MEYERS. I would like to ask you a question regarding a news report from Business Week that I have before me that concerns EWE Properties, which was, in effect, an SBA affiliate and funneled $5.5 million from the agency into improvements at a ski resort that had already failed. It was already in receivership.

It sounds from the magazine article as if EWE was made up of people from the SBA itself and that somebody within SBA said that this was a legal arrangement. It sounds very questionable to me and I would like someone to comment on it.

Ms. ENGELEITER. I would be happy to comment. The longer version of my written testimony goes through the whole history of how we came to this situation that we are at today in terms of

having a 90-day moratorium on this program and making some positive, constructive changes.

The attention on the whole problem of the SBIC program was brought to my attention last fall, late last fall when I received an Inspector General's report that had to do with the EWE liquidation. I did not cover the program broadly, but talked about this particular matter that you are speaking of.

In response to that, we did a variety of things, including bringing in a reputable outside firm to take a look at the entire liquidation portion of the SBIC program. This Inspector General's report honed in on the way that one liquidation was handled, but it raised enough questions in my mind and in the minds of our senior staff at the SBA that we felt that we needed to look at the entire program.

The study was done in stages, and the initial stage looked at the whole liquidation process for the SBIC program. The second stage looked at the front-end of the program, the regulations that the agency has in order to determine who ought to be participating in the program and what the regulations are for their participation. It was an outgrowth of that study that has brought us to the point we are at today of having made a number of very significant constructive changes in this program.

I would turn it over to our general counsel to bring you up to date on the history of EWE per se. It was an incident that took place prior to this administration, and that came forth as a result of the Inspector General's report last year.

Ms. NAREY. I would be happy to give you a little background on the EWE situation and where it is currently. At one point there was a fairly large SBIC called Royal Business Investment Funds that went into liquidation status that had a number of subsidiary corporations that had extensive real estate holdings and a variety of different holdings, but had a significant number of subsidiaries. Several SBA employees incorporated EWE to manage the liquidation of that SBIC and to consolidate all the subsidiaries under one umbrella organization.

I should clarify that all of the stock of the EWE Corporation was owned by the SBA. It was an SBA-owned corporation. Ultimately the question arose as to whether or not that could take place under the Government Corporation Control Act, and the Justice Department determined that it could not. EWE, the corporation, has been dissolved at this point with the State of Delaware. It was dissolved this summer. There are still a number of holdings that are left over that have been transferred to the SBA. One of which is the ski resort in Colorado which the SBA is actively trying to market and sell. There are some negotiations currently underway with investors to purchase that ski resort, and we are very hopeful that one of them will be fruitful and we will be able to sell it as quickly as possible.

The question of development of the ski resort, I guess, is one that certainly anyone can question in terms of hindsight. One of the collateral holdings of the Royal Business funds that ultimately was inherited by EWE, so to speak, and there was obviously a question of whether it is better to just unload it as it is, or whether it is better to try to develop it and then sell it and make a better recovery for

the Government. I think that is what took place was a feeling that perhaps a greater recovery could be made on behalf of the Government if certain actions were taken.

Hindsight, of course, is always 20/20, but I can assure you that EWE has been dissolved and will not arise again in any context within the SBA. Also, that we are very actively trying to sell the ski resort in Colorado as quickly as possible and make the best recovery for the Government.

Mrs. MEYERS. How many people participated in that action?

Ms. NAREY. In which action?

Mrs. MEYERS. I have an indication in front of me that there were a number of management changes made in June of last year, and that all these people were associated with that EWE action. In fact, who drafted the legal opinion that sanctioned it?

Ms. NAREY. There was a lawyer from my office who initially drafted the legal opinion some years ago establishing it, and it required construction. Ultimately we looked at the Government Corporation Control Act, which I will not go into a detailed legal analysis with you at this point, but it is not a totally straight forward act in the way that it sets forth when a corporation can be formed under the Government and when they cannot. If you would like, I would be more than happy to sit down with your staff or with you at some later point and go into the details of that statute.

The individual who was responsible for drafting the legal opinion in my office is no longer overseeing any SBIC matters, and I believe there have been some changes made with respect to the other individuals who were involved with EWE Corporation as far as their involvement in the SBIC program.

Mr. CRUSTO. Congresswoman Meyers, in relationship to the EWE matter, those individuals set up a receivership to assist in the liquidation process. It is not uncommon for receiverships to be set up. What was uncommon in this particular instance was that SBA employees were basically officers of that entity.

To date, there has been no indication that those individuals personally benefited from that arrangement; that they were attempting to perform their duty in the liquidation function. At this point in time those individuals are no longer overseeing the SBIC liquidation process. There are basically three individuals involved, and neither of those three are presently involved directly with SBIC liquidation cases.

Mrs. MEYERS. When they formed EWE, did they request an opinion or was EWE formed secretly?

Ms. NAREY. It is my understanding that it was not a secret endeavor at all. The stock, as I mentioned, was 100 percent owned by the SBA, not by these employees, and they were officers of the corporation, but the stock was 100 percent owned by the SBA itself as an agency.

Now, we were not around at the time that it was formed, but it is my understanding that there was certainly no secret.

Mr. CRUSTO. No; this went through a clearance process. I believe there was an opinion of counsel at the time giving the opinion to the Investment Division that this would be acceptable, an acceptable arrangement. But once again that took place prior to our coming on board.

Ms. NAREY. I might also mention that at the time, as Mr. Crusto has said, there was a receivership to liquidate the funds of Royal Business Investment Corporation, and that was overseen by the court. In fact, the court was aware that this corporation owned by the SBA was going to take over liquidation of that particular SBIC.

Again, as Mr. Crusto mentioned, I think as I said, given the limited resources within the SBA at the time, the feeling, and again hindsight is always perfect, that this was a more effective way to manage liquidation of the SBIC, but certainly there has been absolutely no indication that there was anything intended as an impropriety on the part of any of the employees involved.

Mrs. MEYERS. Ms. Engeleiter, you said that the liquidation process was being studied by an outside firm and that it was being studied in stages. Who is the outside firm and at what stage are we with that?

Ms. ENGELEITER. In my statement, Congressman Meyers, I went through the steps that we have taken in changing our liquidation process. There was an outside firm, the name of the firm is Irving Burton. They completed their study earlier in the year, and we have taken the steps internally. I can run through them all.

We have recovered over $25 million, closed 28 SBIC liquidation cases, written off about $30 million as uncollectible. We have 20 additional cases totaling $75 million that are targeted for resolution by the end of the calendar year. We have identified cases in which SBIC's that are in receiverships have excess cash in their accounts, and we have moved those funds back into the SBA. In fact, one case alone collected over $1 million.

We have completed liquidation plans for five SBIC's that have not complied with settlement agreements that they already had with the agency. We have implemented new procedures to independently value the assets of SBIC's that are in liquidation, and the assets acquired from the failed SBIC's that voluntarily assign their assets to SBA.

We have also taken steps to revise internal accounting procedures that was very much needed to ensure that losses anticipated in liquidation proceedings are recognized immediately upon transfer to SBA, which was not always happening in the past, and we have no procedures to involve senior management in the agency in the liquidation process, which was not being done before, and strengthen the guidelines for approval of expenditures in the agency relating to the liquidation of acquired assets. We also have developed new operating procedures for SBIC's that are in receivership, and we have restructured the SBIC liquidation section.

Mrs. MEYERS. When was all this done, Ms. Engeleiter?

Ms. ENGELEITER. All this year.

Mrs. MEYERS. This year?

Ms. ENGELEITER. Yes.

Mrs. MEYERS. But the bottom line is still probably that we will lose between $300 million and $400 million?

Ms. ENGELEITER. We just discussed that. We are going to be providing in detail to the committee the best estimate that we can give you. The exposure to the Government, there were $500 million that has been paid out essentially. We are hopeful that the agency will be able to collect a good amount of that. I think it is important

to remember that some of the receiverships, as I mentioned before, that we are closing out are 20 years old. Unfortunately, this program that is a much needed program, that is a good program, is going to have an artificially high reflected losses in a couple of years here because there were losses that were not written off 20 years ago, and that is very unfortunate for the program, and I think it is important for all of us—I think it is your responsibility as Members of Congress, as I said in my opening remarks, to determine what you think is an appropriate level of risk for the Government in order to provide long-term debt financing and equity financing for small businesses in this country. It is our responsibility to see to it that money that was owed the Government over the course of many years is collected. But it is too bad that the program will have these high losses. Perhaps our general counsel would like to——

Chairman LAFALCE. I think we are going to have to go on. We have spent a considerable amount of time because these were extremely important questions and we wanted to flush them out, but we do have to be fair in allocating time for any more questions.

Mr. Torres.

Mr. TORRES. Thank you, Mr. Chairman. I was late coming here. We were involved in the House Senate housing bill, and that delayed us, so I apologize for coming in late, and I was not able to then make an opening statement, Mr. Chairman. I would ask unanimous consent that my statement be entered in its entirety into the record.

Chairman LAFALCE. Without objection, so ordered.

[Mr. Torres' statement may be found in the appendix.]

Mr. TORRES. Thank you. I want to commend you, Mr. Chairman, for calling this very important meeting and very important witnesses today. I want to thank Ms. Engeleiter, of course, and Mitch Crusto and the staff for coming before us to talk to us about SBIC's and the important role they have in the private/public sector partnership.

Perhaps, Ms. Engeleiter, in your answer to Mrs. Meyers in the EWE issue, you alluded to the Inspector General's investigation and study that went into that which precipitated additional studies by the Inspector General at the request of the Investment Division. Am I correct?

Ms. ENGELEITER. Yes.

Mr. TORRES. For SBIC's that are not covered on what you call onsite visits, you provided a one-time financial and regulatory analysis disclosure statement to give you details on the status of that SBIC regarding their financial health. My question would be then, how will the Inspector General, deal with the responsibilities of SBIC's independent public accountants?

Ms. ENGELEITER. As I mentioned in my testimony, we are contemplating a major study of the value of the portfolios of all SBIC's which certainly would have Federal leverage, and that will require rather considerable resources. But in light of the fact that——

Chairman LAFALCE. Let me stop you there, Ms. Engeleiter. What resources from the SBA? Are you going to contract this out? If you are going to contract it out, who are you going to contract it out to,

or how are you going to offer it for bid? How much is it going to cost? Where are you going to get the money?

Ms. ENGELEITER. We have not gotten that far, Mr. Chairman.

Chairman LAFALCE. Yes; I know you have not which is why I am asking it. But I think that is a fairly relevant question.

Ms. ENGELEITER. Yes; it is a relevant question, and we are looking to do the most that we can with stretched resources, frankly, in our Inspector General's office.

Chairman LAFALCE. You cannot do it internally. You know that. It is going to require——

Ms. ENGELEITER. We cannot do it internally if we are going to look at all SBIC's and their portfolios. As I mentioned in my testimony, we may need your assistance in terms of coming up with changes or resources in order to do what we think needs to be done.

Chairman LAFALCE. Yes; we are going to——

Ms. ENGELEITER. We will get back to you.

Chairman LAFALCE. We are going to need a request. We are going to need to know where you want to go and when you want to go there, et cetera, and time is marching on.

Mr. CRUSTO. Mr. Chairman, in reference to Congressman Torres' comment——

Chairman LAFALCE. Mr. Torres, you will get a lot more time.

Mr. TORRES. Yes; thank you, Mr. Chairman.

Chairman LAFALCE. I just did not want to let that one go by.

Mr. TORRES. Fine.

Mr. CRUSTO. It was in an effort to get a current picture of the health of the SBIC industry that we asked for this one-time financial disclosure, similar to the type of disclosure perhaps that the Securities and Exchange Commission may required on a current basis.

Unfortunately, within the present regulatory structure that we have, it is very, very difficult to get a present picture of the health, the financial health of an SBIC. As you know, the Inspector General does audits every other year. We get financial reports every year, but the fluctuations that can occur in between those periods of time leave a lot to be desired and provide an exposure to the Government if there are losses in the investments by an SBIC.

Mr. TORRES. Once again, how will the Inspector General concentrate on the responsibilities of independent accountants and their responsibilities?

Mr. CRUSTO. I really cannot speak for the Inspector General. I really do not know how he is going to go about doing that. We are trying to assist him in providing current information in order to provide a more accurate picture of the present health of SBIC's.

Ms. NAREY. Congressman, one of the things that I think the regulatory changes that are contemplated is intended to address is the whole question of the role of the independent public accountant in evaluating the SBIC's and the sorts of information that those independent public accountants provide to the SBA.

Certainly if they provide some different information, more extensive information, have a somewhat changed responsibility in terms of reviewing the valuations that the SBIC has set for their investments and provide that information to us, it should provide assist-

ance to the Inspector General with respect to his or her review of those particular statements provided by the independent public accountants.

The Inspector General, obviously, will make the determination in terms of how they relate with those statements, but one of the things that we are doing is trying to take a closer look at the independent public accountants' role with the SBIC's and what the implications of that are both now and going forward.

Mr. TORRES. Thank you, Mr. Chairman. I have no further questions. If I have time, I yield it back.

Chairman LAFALCE. You have additional 10 minutes, but thanks for yielding.

Mr. Machtley.

Mr. MACHTLEY. Thank you, Mr. Chairman. I too apologize for not hearing all the testimony, but I think it is a very timely hearing because the articles which I am reading from various periodicals are indicating that perhaps as many as one-fifth of the total portfolio may be in trouble. Is that an accurate statement?

Mr. CRUSTO. I do not know if one-fifth is an accurate statement, but certainly right now the appearance is that there are quite a few that are in trouble. If you would liken this perhaps to a mutual fund that when there is a drop in the market loses value. It takes time basically for value to rebuild. Unfortunately with some of the SBIC's, because they are borrowing money from the SBA, they really do not have that time, so it does put a little bit of a crunch on them at this point having experienced some losses in value. At this point in time we are going through the process of evaluating where the losses are and whether or not those SBIC's have time.

Mr. MACHTLEY. The concern that I would have is not for whether we continue the SBIC, I think that is a separate question, but for those who are currently in the program, who are going to need additional help. They are not going to be able—as the recent hearing this committee had on the credit crunch has pointed out—to turn to traditional banking facilities and get help. If for argument sake one-fifth are in trouble, what that tells me is that just to keep those afloat is going to take enormous sums of additional money. Have you any idea and program for what may happen to those existing?

Mr. CRUSTO. It is very difficult to give you a clear picture because each SBIC is different. Each SBIC invests in a different portfolio and has a different investment strategy, so it is hard to generalize. We know that we have $1.2 billion outstanding. Certainly a number of SBIC's are in perfect health and doing very well, and actually have very positive cash flows and very rosy futures. But once again the nature of investing in small business is risky business. Unfortunately, because of our debenture financing, we are not in a position to give them time.

If Congress considered some means of providing a subsidy of source to, or allow for a deferral of payments on debentures, that may be one possible solution, recognizing the fact that most SBIC's certainly went through the process of investing in small business pursuant to the purpose and intention of the program. At this point in time, quite frankly, a number of these are going to go

under, not through any malfeasance on their part, but, unfortunately, just as a result of market conditions.

Mr. MACHTLEY. Let me ask the question differently then. How much money do you expect—if you have ever done a study—is going to be needed to keep the existing SBIC programs functioning?

I do not want this to be another savings and loan crisis. As that savings and loan crisis developed, we heard numbers of $55 million and then it went on up, and today we are still not sure. My question is, do we need more money to help the existing SBIC or are they OK?

Mr. CRUSTO. I think perhaps the trade association might be in a better position to give you that figure, but we do not have at this time an adequate picture of the health of each SBIC to give you that.

Mr. MACHTLEY. Do you anticipate that you would need any additional moneys?

Ms. NAREY. The question in the SBIC program really is not that we—the SBIC's, when they come to the SBA for funding, have to demonstrate certain financial responsibility and capabilities before we agree to guarantee their debentures. There really is not any money expended at that time apart from the guarantee.

Providing additional funding, the question then is do we provide additional funding for SBIC's that are in trouble when we know they are in trouble, and that presents sort of a catch-22 because one of the things that we obviously are obligated to do is to try to protect the Government's interest as best we possibly can. So, there is a difficult situation that is presented, because obviously the SBIC program has been of great assistance to small businesses in terms of helping small businesses get going and have start-up equity financing for them, and that is obviously something that we are very supportive of, and the SBIC program has done well over the year. At this current time it may be particularly crucial, and I think that has to be balanced against, obviously, our necessity to protect the Government's interest insofar as funds that are being either expended or else debentures that are being guaranteed and whether or not that should be done with respect to SBIC's that are in trouble, as you say, is really a question that is sort of a philosophical debate.

One of the things that the administrator said initially in her statement is that what we are looking for from Congress and to discuss is what level of risk is acceptable generally in the SBIC program, and that certainly ties into the question that you are asking.

Mrs. MEYERS. Would the gentleman yield?

Mr. MACHTLEY. Certainly, I would be happy to yield.

Mrs. MEYERS. You said that the SBIC's must prove certain standards of safety and soundness when they come to the SBA to receive money. Could we see what those criteria are, and have you changed them at any time since we realized we were in trouble?

I think, Mr. Chairman, that we should get absolutely as much information on this topic as we can, because hindsight, it is easy to look back and see what you should have done. But in talking with a number of my colleagues who were here 10 years ago, they have told me about the questions they wished they had asked in relation

to the S&L's then, and I do not think we should leave any questions unasked right now.

If we have an estimate of $300 million to $400 million that is lost, I do not know how long that is going to be before it would be $1 billion. I want to know, and I want to know the worst case scenario and I want to know what you are doing and what you are changing so that this will not get worse.

Mr. CRUSTO. Let me give you a little bit of a thumbnail sketch that might be helpful to you. We are required by law to provide quarterly funding opportunities for SBIC's where they basically offer debentures to the public and SBA guarantees those debentures. We have just completed one of those quarterly fundings.

In that quarterly funding, $77 million was requested by the SBIC's to be funded. Going through our process of what we call scrub down, evaluating whether or not the SBIC's who are applying have fulfilled their regulatory responsibilities as well as their financial responsibilities and looking at their financial credit picture, we only funded $17 million out of that $77 million funding request.

So, we are acting in a very responsible manner and doing, quite frankly, a much due diligence. It is a balancing act. On the one hand we recognize a need for capital to be available for small business. We recognize a need for the SBIC's to continue their operations which sometimes require new funding. At the same time I think we have been fairly stringent within the last couple of years and scrubbing down, quite frankly, the requests being made.

We recognize that this is where the money basically comes at risk. I mean, once SBA approves what we call leveraging the funding, that is where the Government's obligation, quite frankly, financial obligation comes into play.

Chairman LAFALCE. Thank you, Mr. Crusto.

Mr. Lancaster.

Mr. LANCASTER. Thank you, Mr. Chairman. Ms. Engeleiter, I just have a question about the new licensing requirement that you published in the Federal Registry in the form of an interim final regulation.

First, how do these differ from previous regulations listed on page 5 of your testimony?

Second, why should these not be retroactive? Should not existing SBIC's be held to a higher standard?

Third, it sounds to me like staffing is still going to be minimal at best for these tasks. Are we simply going to increase the workload of your existing staff, or is there some way to address that workload problem?

Mr. CRUSTO. Mr. Lancaster, if I can speak a little bit about the regulations. The regulations came out of our evaluation over the last few months of perhaps some of the shortcomings of our regulatory process. We want to make sure that we provided the maximum amount of protection of the Government's money without strangling, quite frankly, strangling the program.

One of the major responsibilities now under the new regulation is to reduce our exposure based on the subordination of a provision that we presently have in our regulations.

Within that subordination arrangement if an SBIC wanted to borrow money from other entities, not the SBA, the SBA would take a subordinated position to those new funds. We found that if an SBIC went under, in the liquidation process the Government basically was last to collect and therefore did not collect anything. We are now trying to put a reasonable limitation on subordination, allowing some subordination but having a closer ratio to the private capital that is in the SBIC. Those are the types of things that we have dealt with.

Another major regulatory proposal in that group is in the average of leveraged buyouts. We found a number of SBIC's, usually owned by large banks, were using the SBIC program to assist in fairly large financial deals that included leveraged buyouts of fairly large companies that met our size standard once the new financing was arranged due to a heavy overlaying of debt. We found that to be inconsistent with the true intent of the program. Once again, we promulgated a regulation in that regard.

We believe that these regulations will help to guide the program to the true intent that Congress established—created in establishing this program, which is to help small businesses.

We do not believe at this time that it will put undue burden on the staff, although we have put in a request and we are adding to our staff not only on the liquidation side, which is what the administrator has mentioned, but, in addition, on the Investment Division side. She has also approved five new positions in the Investment Division side, and we are in the process of hiring those individuals as well. We are also trying to modernize our process and make our group a little bit more efficient in reviewing the SBIC portfolio.

Mr. LANCASTER. But what about the subject of retroactivity?

Ms. NAREY. Are you speaking about the minimum capital requirements, the change in the minimum capital requirements specifically?

Mr. LANCASTER. The whole issue of retroactivity, because it appears to us from reading your statement that this is going to only apply prospectively and not retroactively.

Ms. NAREY. Some of those changes would be virtually impossible to apply retroactively. A subordination change, for example, I mean the agreements have already been made with banks or whoever the SBIC's are dealing with. The minimum capital requirement is being increased for new SBIC's licensed prospectively from $1 million to $3 million for regular SBIC's, and to $2 million for specialized SBIC's. It is also contemplated for SBIC's currently in the program, I believe, that they will have one year to come up to those increased capitalization requirements.

The reason for that is they came into the program under one set of criteria and it was felt a reasonable thing would be to give them ample time to raise the additional funds.

Mr. LANCASTER. You were going to comment, sir?

Mr. NEWELL. Basically, I was going to say precisely what she said.

Mr. LANCASTER. Thank you, Mr. Chairman.

Chairman LAFALCE. Thank you.

Mr. Conte.

Mr. CONTE. I really apologize for coming in here late, Mr. Chairman. Trying to solve this budget crisis. How long is it that SBA has not had an Inspector General?

Ms. ENGELEITER. He has been gone about a month, I think.

Ms. NAREY. About 4 or 5 weeks.

Mr. CONTE. How long was he on board before that?

Ms. ENGELEITER. He was there before this administration, and I cannot tell you how long he was there in the last administration.

Ms. NAREY. No; I cannot either. I think it was about 3 years maybe, 3 or 4 years.

Mr. CONTE. Would it not come under his jurisdiction to sort of look into these SBIC's? I find, as the ranking Republican on appropriations, sitting on all 13 appropriation committees, that Inspector Generals are a real class act and can do a tremendous job, as they do in Health and Human Services and Defense and all the others. Would it not be in his bailiwick here to keep an eye on these thing agencies?

Ms. ENGELEITER. The Inspector General is required, his Audit Division, to review the SBIC's every 2 years. It was previously every year and that was changed, I think, a couple of years ago to every 2 years. He does have limited resources within his staff to perform those audit functions, but there is a statutory requirement that the Inspector General's office audit the SBIC's every 2 years. Then, of course, in the event that there are some alleged improprieties or whatever that may come up, the Inspector General's Office of Investigations may become involved in individual cases if requests are made or if some questions are raised about specific SBIC's.

Mr. CONTE. You say he has a very limited staff and his jurisdiction goes way beyond SBIC's.

Ms. ENGELEITER. Absolutely.

Mr. CRUSTO. Yes, sir.

Mr. CONTE. Was it the fault of Congress that we did not give you enough money for this particular phase of SBA?

Ms. ENGELEITER. The Inspector General has a separate budget from the rest of the agency.

Mr. CONTE. I know he does.

Ms. ENGELEITER. So I am not sure we are in the position to comment specifically about his budget requests in the past, but we could certainly comment.

Mr. CONTE. You do say he had a very limited staff, so it indicates that he could have used a lot more staff to look into these things.

Mr. CRUSTO. Mr. Conte, in fairness to the Inspector General, we have experienced volatile markets in the last 3 or 4 years in this country. Just recently, of course, in the real estate market in New England, which is one indication of the type of scenarios that we see out there.

I think the Inspector General does an adequate job in reviewing every other year the SBIC's. But we basically need more current information. Once again, an investment in an SBIC can fluctuate from month to month. So to hold them—I mean, they do basically the regulatory and financial audit or examination, but it is only a part of the regulatory process.

Mr. CONTE. Do you not think that it would be wise to have them review the SBIC's on an annual basis or semi-annual basis?

Mr. CRUSTO. I believe, sir, it was the act of Congress that changed it to every other year.

Mr. CONTE. We ought to look into that.

Chairman LAFALCE. As I recall, was that not the specific request of the administration because the prior law required an annual audit of every single SBIC, and the administration argued, as I recall, please change this because if we have to audit every single one every single year, we will not be able to adequately audit those that we believe should be audited. Is that correct?

Ms. ENGELEITER. It was prior to this administration, Mr. Chairman, so we cannot speak to that. I am sorry.

Chairman LAFALCE. Was that not in——

Ms. ENGELEITER. No.

Chairman LAFALCE. Yes; in 1988. But that was the specific request. If you have to audit every one every single year, it cannot be done, so let us change that so that we can audit every other year and therefore we would be able to concentrate our energies. This was specifically requested by the administration.

Mr. CONTE. You may not be able to audit every year if you do not have the personnel. But if you have got the personnel, you can do it. I have been following the Inspector General. In fact, myself and Senator Glenn have just filed legislation because Justice was very upset that Inspector Generals were overstepping their turf, and I have been a strong supporter of Inspector Generals.

I think if you have enough of them—how many do you have in the Department, in SBA?

Ms. ENGELEITER. We have one.

Mr. CONTE. One.

Ms. ENGELEITER. Presidentially appointed Inspector General.

Mr. CONTE. That is a joke. That is a joke.

Ms. ENGELEITER. For SBA.

Ms. NAREY. The one Inspector General who has a staff.

Mr. CONTE. All right, how much staff?

Ms. NAREY. Forty or—we would have to check into that exact number?

Mr. CONTE. How many did you say? Five?

Ms. NAREY. About 55 auditors.

Mr. CONTE. That is not very much with the case load you have got out there. How many SBIC's are there in the United States?

Mr. CRUSTO. There are approximately 389 presently licensed. Now that we are renewing licenses, we expect more to be added.

Mr. CONTE. OK, thank you, Mr. Chairman.

Mr. CONTE. Mr. Flake.

Mr. FLAKE. Thank you, Mr. Chairman. Let me just ask a question following Mr. Conte. You say there are 389 licensed SBIC's. You have 170 SBIC's in liquidation? Is that 170 of the 389?

Mr. CRUSTO. That is in addition to the 389. The 389 is an active number.

Mr. FLAKE. Three hundred and eight-nine active.

Mr. CRUSTO. Yes, sir.

Mr. FLAKE. One hundred and seventy in liquidation.

Mr. CRUSTO. Yes, sir.

Mr. FLAKE. All right. So that means that if those SBIC's were not in liquidation, you would have well over 500 SBIC's that you would have to deal with.

Mr. CRUSTO. To get the full picture, there were even more licensed in the past, some of which have either paid off their indebtedness and gone out of the program, or turned in their licenses.

Mr. FLAKE. What is the total portfolio in terms of dollars that you have in these 389 SBIC's?

Mr. CRUSTO. The Government investment is $1.2 billion, approximately $1.2 billion.

Mr. FLAKE. You have $1.2 billion. In the 170 SBIC's that are in liquidation, you have about $500 million that is owed to it?

Mr. CRUSTO. That is correct.

Mr. FLAKE. In those SBIC's, do you have an equity share?

Mr. CRUSTO. I am sorry?

Mr. FLAKE. What does SBIC do? Does it take an equity position?

Mr. CRUSTO. The $500 million is the Government amount that is at risk. That is the amount in liquidation. In fact, once an SBIC goes into liquidation, we pay the debenture holder, if it is a debenture, on that amount, and then we try to collect against the assets of the SBIC. So $500 million has already been paid to debenture holders of SBIC's in liquidation over the years, and we are now in the process of collecting against that.

Mr. FLAKE. The primary responsibility for that collection rests within the staff that you have as opposed to outside contracted?

Mr. CRUSTO. It is a combination of in-house and outside contractors. There are a number of ways that liquidation can take place. For example, one instance is that the SBIC could negotiate with SBA to make payment over time. That could be by a settlement agreement. Probably the other extreme would be if the SBIC filed for bankruptcy. In which case it is, in effect, taken out of our hands and put into the hands of a bankruptcy court, and then we would basically participate as a legal party in the bankruptcy court. So, there is a number of variations on what can happen which makes, once again, the calculation of losses difficult because of the number of instances we are really not in control of that portfolio in liquidation.

Mr. FLAKE. There is a great deal of paranoia, obviously, within the Congress and within the body of the Nation in part because of what has happened in the S&L crises. One part of your testimony, Ms. Engeleiter, indicates that you lose staff to other agencies, RTC, FDIC, and so forth, in part because persons coming into your agency are paid at a grade or so below that of other agencies. Are you generally losing these persons to other Government agencies or are they going out into the private sector?

Mr. CRUSTO. If I would, it is not so much that we are losing people as it is that it is very difficult for us to recruit against RTC that is allowed to pay at least a 10 percent higher salary because they are on a different scale than the SBA is.

Mr. FLAKE. So you do not get the people in the first place.

Mr. CRUSTO. Absolutely.

Mr. FLAKE. Then when you get them, what is the retention rate?

Mr. CRUSTO. I do not have those figures.

Ms. ENGELEITER. We are currently, as I indicated in my remarks, we are currently looking to hire people because we need to do that. So we are finding that we are having difficulty because of the RTC wages that they are able to pay. So it is more of a prospective issue in terms of our needing more personnel and having trouble recruiting them.

Mr. CRUSTO. Just as an added point, our retention has been fairly good. But it has been on a cap, so it is hard for people to have any type of growth potential. I have been corrected. Actually, the FDIC can pay 20 percent higher than what the SBA pays in a similar category.

Mr. FLAKE. They are paid 20 percent more. Who set the cap?

Mr. CRUSTO. Our caps are set by our normal personnel, Government personnel standards, and the RTC, of course, is in a different category.

Mr. FLAKE. Is it within the purview of your agency to request of this Congress that that cap be lifted so that we do not get to that point where our paranoia becomes reality by virtue of the fact that you did not have the wherewithal by virtue of the limitations placed on you to be able to solve problems as opposed to coming to the point of a crisis?

Chairman LAFALCE. If I may interrupt you, Mr. Flake. It would not be necessary to have legislation.

Mr. FLAKE. You do not?

Chairman LAFALCE. This is purely an administration determination. They could, with the agreement of OMB, eliminate the differential instantaneously.

Mr. FLAKE. Is that within the mindset of this administration to do so?

Ms. NAREY. We can certainly meet with the Office of Personnel Management and OMB to discuss what course of action could be taken to assist us as far as recruiting personnel to compete effectively in terms of encouraging people to come to the SBA as opposed to the FDIC or RTC, who are different within the Government, the applicability of certain requirements on them that do apply to us. So, one of the things we need to look at, one of the things FDIC and RTC have been able to do because of their status—I am not an expert on this, but sort of a quasigovernmental entity that is not subject to all the requirements that agencies like the SBA has been to offer higher salaries to recruit people.

The private sector, as you mentioned, is also a factor. Given all the S&L activity and banking activity, the whole question of liquidation, workouts and all of that has become a fairly active marketplace for lawyers and investment-type people. So the private sector is another thing that we have to face, certainly in the Office of General Counsel, not only in the Washington, DC, area but also throughout the country. The question of quasigovernmental agencies like the FDIC or the private sector is an enticement to people.

Mr. FLAKE. When does this become weighed against the cost to the Government if we have to come in and do with your agency as we have had to do with S&L's. The potential cost is go great that I think one ought to view whatever you pay to solve the problem and resolve the problem before it becomes a crisis as an investment. If it is within the purview of your agency to lift the salaries if that is

what it takes to solve the problem and avoid a crisis, I would suggest strongly that you do so. Because I do not think that the American people are ready to take another hit.

Ms. ENGELEITER. We certainly concur with what you are saying. Those steps that can be taken within the agency to upgrade positions have been taken. We are pursuing with the Office of Management and Budget and the Office of Personnel Management some changes that they need to sign off on in order for us to be more competitive. We are initiating that, because it has become a problem.

Mr. FLAKE. My time is up. Let me just ask one final question. The 90-day moratorium, is that still operative at the moment?

Ms. ENGELEITER. The moratorium sunsetted on September 30, so we are now issuing licenses.

Mr. FLAKE. You have done everything that you feel is within your capability and responsibility to create an efficient means by which you can move beyond this 90-day period?

Ms. ENGELEITER. Yes; it is our view that we can responsibly have this program continue in operation, that we have taken significant steps to improve the program. There certainly are some unfinished business that does not have to do with lifting the moratorium that needs to go on in the agency. We would and we are exploring within our own resources and will be having further communication with the committee in terms of trying to get a valuation, an outside valuation, of the current SBIC portfolio.

Because of the billion dollar Government exposure there, that needs to continue. But the moratorium has been lifted, and we can tell you in good conscience that we think that that was a responsible thing to do.

Mr. CRUSTO. Congressman, just to give you one point of overview. Adding staff and changing procedure at this point would help reduce some of the risk of the program. But once again because of market losses, there are SBIC's that are having financial difficulty at this point in time. There is very little that the SBA can do short of a capital infusion or allowing them time to have their investments turn around. We are not in the position under regulation or law to do that.

Mr. FLAKE. Mr. Chairman, thank you very much for allowing me the time.

Chairman LAFALCE. You are very welcome. We are going to have to get on to the other witnesses. But before we do, just a few things. In 1986 when Congress was enacting legislation to change SBIC debentures to private sales rather than sales to Treasury, it is my understanding that the investment division at that time estimated that losses under the SBIC program would ultimately total about 12 percent. Am I correct in that recollection, do you know?

Ms. ENGELEITER. I am not certain of that, Mr. Chairman. I would be glad to provide that for you for the record.

Chairman LAFALCE. Does anyone else here?

Ms. NAREY. We would have to provide you with that information, Mr. Chairman.

Chairman LAFALCE. What is the estimate today as to the losses under the SBIC program, do you have a percentage?

Ms. NAREY. As indicated earlier when we were talking, the estimate on this loss projection that we have of the total portfolio of $1.2 billion, the active portfolio, the estimate of default rate on that which is the only figure that I have before me at this point is 28.5 percent. That is the default rate.

Chairman LAFALCE. What is the difference between a default rate and the loss rate?

Ms. NAREY. The ultimate loss rate as revealed here taking into account the projected losses based upon the estimated default rate, the actual net losses that have taken place and the allowances for losses in the current liquidation portfolio, that total actual and estimated loss rate here as revealed is 12.8 percent.

Chairman LAFALCE. I think that it is important in discussing the program to distinguish between loss rate, default rate, et cetera. For example, when we talk about liquidation, what does it mean to be in liquidation, what is a SBIC in liquidation?

Mr. CRUSTO. Mr. Chairman, a SBIC can go into liquidation for a number of reasons, and probably there are two main categories. One is through a default in a debenture payment. That is usually the number one reason.

Chairman LAFALCE. If you make an analogy to a home, if you did not make a mortgage payment for one month, you would be in default or liquidation.

Mr. CRUSTO. You would be in default to the Government on the debentures that we held.

Chairman LAFALCE. That automatically puts you in a class called liquidation?

Mr. CRUSTO. I would say close to automatic, unless there is some extenuating circumstance. We will communicate with the SBIC.

Chairman LAFALCE. What do you mean, what puts you into liquidation, what makes you put somebody into liquidation?

Mr. CRUSTO. Liquidation is a category that basically SBA determines based on a set of criteria.

Chairman LAFALCE. Would one default do it, or would there have to be several defaults?

Mr. CRUSTO. There would not be an automatic liquidation. You would not be put into liquidation automatically because of a default. If you are not making a payment, as your mortgage company might, we will contact the SBIC to determine why a payment had not been made, and whether or not the payment would be forthcoming in the future.

Mr. NEWELL. To be placed in liquidation means as a practical matter that you are being transferred from the status of an operating SBIC under the investment side to a SBIC in liquidation status in our office of portfolio management.

Chairman LAFALCE. What is the difference, and what does that mean, does that mean you are in a work out situation?

Mr. NEWELL. Yes.

Chairman LAFALCE. That does not mean that you are in bankruptcy, it does not mean you are in insolvency, but does it mean that you are going to get closer scrutiny, or you are going to have to enter into an operational agreement where you can or cannot do certain types of things where your latitude is decreased, what does it mean?

Mr. NEWELL. First of all, it means in most cases that as a result of your financial condition, and as indicated probably default on principal or interest on your obligations coupled usually with a serious impairment of capital, or as a result of significant regulatory violations which the SBIC was unable or unwilling to correct, that a decision was made that the company should be no longer operating as a SBIC under standard operating procedures, but that it should be transferred to the liquidation unit where appropriate action would be taken to recover the Government's indebtedness.

Chairman LAFALCE. Does that mean that it cannot operate as a SBIC?

Mr. NEWELL. Excuse me.

Chairman LAFALCE. Does that mean that it can no longer operate as a SBIC, or does it mean that it can operate as a SBIC but under different strictures?

Mr. NEWELL. The liquidation section will work that out in terms of how they will go about the liquidation of the SBIC. It may be that they may enter into an agreement with the SBIC where they continue to operate but operate solely for the purpose of liquidating the assets and paying SBA off.

Chairman LAFALCE. When you are in liquidation, does it mean that you automatically have to have all of your assets liquidated, or does it mean that you might be able to engage in some type of a work out, so that you can come out of liquidation? From what you describe, it sounds like once you are in liquidation that is it; it is all over. Is that really the case?

Mr. NEWELL. In most cases, yes.

Chairman LAFALCE. Need it be the case, and what percentage of the cases, what is most, 90 or 51?

Mr. NEWELL. It is very rare that companies come out of liquidation back into the operating unit.

Ms. NAREY. It would though, Mr. Chairman, as I understand the way that the liquidation office operates, depend upon what the situation is that has caused the SBIC to be put into liquidation status. If there have been defaults and the Government has paid the debentures and it is then in the liquidation status because of financial reasons, that may be one situation. If it is because of a regulatory problem that ultimately is corrected, as I understand it, Joe, that may be a different situation.

Chairman LAFALCE. What is the nature of a regulatory problem that would put you into liquidation?

Mr. NEWELL. Serious conflicts of interest that go uncorrected notwithstanding efforts on the part of the agency to obtain corrective action.

Chairman LAFALCE. What percentage of the cases in liquidation are there for financial reasons, and what percentage are there for regulatory reasons?

Mr. NEWELL. While I certainly do not have the actual percentages, I can certainly say that most of the cases, and I know that you hate that term most, but most of the cases happen to be there for financial reasons, because of default situations and because of serious impairments of capital.

Chairman LAFALCE. I use the term frequently, whenever I want to hedge. But I just want an idea. Would we be talking closer to 50 or closer to 90?

Mr. NEWELL. I think that we would probably be talking closer to 80 or 90 percent of the cases going into liquidation because of financial problems.

Chairman LAFALCE. We have a whole slew of other questions. We are going to have to follow up, because this is not going to go away. This is going to be a biggie. This has got to be a big priority at SBA, I assume. Is that not correct, Ms. Engeleiter?

Ms. ENGELEITER. It has been a very big priority since last fall, Mr. Chairman.

Chairman LAFALCE. Who has been the chief honcho since last fall?

Ms. ENGELEITER. I have been the chief honcho, Mr. Chairman. I would really like to say that I am very proud of our employees who have been working on this issue at the Small Business Administration. I am very proud of the team that has included the people who are here at the table who have spent an awfully lot of their personal time on this matter. In my statement, I said that many of the decisions need to be made at the senior level.

This is not a large Federal agency by Federal standards. It has meant that a lot of us have and will continue to spend a lot of our personal time. I have been very proud of the performance of our employees who worked on a very tough problem that we inherited.

Chairman LAFALCE. Mr. Crusto, you are the Associate Deputy Administrator for Finance, Investment and Procurement. So you have almost everything under you.

Mr. CRUSTO. The main programs, Mr. Chairman.

Chairman LAFALCE. Mr. Newell, you are the Director of the Office of Investment. Now is that not the SBIC program in particular?

Mr. NEWELL. Yes; it is.

Chairman LAFALCE. That is the SBIC program?

Mr. NEWELL. Yes.

Chairman LAFALCE. Did you take over from Mr. Linebury?

Mr. NEWELL. Oh, no, Mr. Kulik.

Mr. CRUSTO. If I could explain, Mr. Chairman. The investment division is headed by an Associate Administrator for Investment by statute. That is the position that Mr. Kulik is presently holding and that Mr. Linebury had previously been previously overseeing. Mr. Newell is directly under Mr. Kulik as the Director of the Investment Division.

Chairman LAFALCE. How long have you been there, Mr. Newell?

Mr. NEWELL. I have been with the division for 25 years. I have been in this particular position for approximately 2½ years.

Chairman LAFALCE. Within the Inspector General's Office, and I know that you are not responsible for the Inspector General, Ms. Engeleiter, but Mr. Gillum went a little over a month or so ago to the Agriculture Department, who within the Inspector General's Office would have particular responsibility for the SBIC program, do you know?

Ms. ENGELEITER. The Acting Inspector General had been Mr. Gillum's Deputy, Mr. Dan Pexser. He is chiefly responsible.

Chairman LAFALCE. He is responsible for everything now, as you are responsible for everything. But within that, is there anybody who heads up the audits of the SBIC's?

Ms. ENGELEITER. Peter McClintock currently heads up that office.

Chairman LAFALCE. Do you know how long he has?

Ms. ENGELEITER. I would say for approximately 6 months or so. He was with the Inspector General's staff prior to that time though.

Chairman LAFALCE. All right. Thank you very, very much. We will have to pursue this much more aggressively, and work with you much more closely. Thank you very much.

Ms. ENGELEITER. Thank you, Mr. Chairman.

Chairman LAFALCE. Will the representatives of the National Association of Small Business Investment Companies and the National Association of Investment Companies, Mr. Wilkinson and Mr. Threadgill, please come to the table. You may bring assistants if you so desire.

Mr. Wilkinson, let us hear from you first.

TESTIMONY OF WALTER H. WILKINSON, JR., CHAIRMAN, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES, AND GENERAL PARTNER, KITTY HAWK CAPITAL LTD, ACCOMPANIED BY PETER McNEISH, PRESIDENT

Mr. WILKINSON. Good morning, Mr. Chairman and members of the committee, and members of the staff. I appreciate the opportunity to testify today at these oversight hearings.

I am Walter Wilkinson, general partner of Kitty Hawk Capital, Ltd., located in Charlotte, North Carolina. I am testifying today in my capacity as chairman of the National Association of Small Business Investment Companies, NASBIC, which is the national trade association for the SBIC industry. I am accompanied by Peter McNeish, the association's president.

NASBIC has submitted for the record approximately 23 pages of testimony which we sincerely hope that the members and staff will read. If after doing so, you have any questions, please call either me or Peter. Our written testimony covers a number of issues in detail.

This morning, I will try to limit my remarks to 15 minutes and deal with the following five subjects. The first is the issue of defaults, liquidations, and financial condition of the program or the industry. The second point is the decline in the number of SBIC's licensed and the decline in the use of leverage.

The third point that I will address is the issue of valuation and accounting issues. Fourth, is our answer to your specific question of should the SBIC's be making debt or equity investments. Last, I will address some recommendations that NASBIC is making on behalf of the program.

The first subject on defaults, liquidations, and financial condition. I am going to get into the numbers which we spent a great bit of time on earlier. But I would just say that on pages 9 and 10 of our written testimony that we go through a process where we de-

scribe using historical data on what the losses have been and what they are projected to be.

The SBA, I believe, reported in some of the Senate hearings that they feel that 85 percent of the SBIC's are in good or satisfactory condition. That number may change depending on the outcome of the Inspector General's reports, I would assume.

As an industry, however, by all categories and subgroups, the SBIC industry was profitable in 1989. As you well know, SBIC's leave the program for several reasons that have been discussed already—defaults, regulatory, and voluntary. The large majority who have left the program over the years has been on a voluntary basis.

As you are also well aware, there are many misconceptions by the press and others between default rates and actual losses, again subject to much discussion previously. Through our analysis, again on pages 9 and 10, we have tried to extrapolate what has been the actual recovery rate of 65 percent of defaults, what has actually been the historic loss rate, and projected. What we come up with is about an 8.5 percent loss rate over the history of the program.

Again that projection is assuming a 65 percent recovery rate and the actual loss rate historically, both which are subject to change, as the SBA discussed, depending on what the current recovery rate is.

Chairman LAFALCE. They were using 40 percent I believe.

Mr. WILKINSON. That number was tossed out one time, and 64 percent was tossed out, which is again what we were using. Our data really has to come from the SBA, and some of that is historical. Going forward, you just have to make assumptions as you pointed out.

But again, following our analysis, if you come up with this overall 8.5 percent rate, and it may be 12.5 which Ms. Narey pointed out, we would project an overall loss rate on the current $3 billion of leverage that has been extended or has been extended and repaid over the history of the program at about $250 million.

We would also point out that one SBIC investment, Apple Computer, generated $250 million in taxes alone last year—one company paying the entire cost of the program.

As you also pointed out in your opening statement, we have invested our private capital and have invested almost $9 billion in the history of the program in approximately 70,000 businesses in all 50 States. So if Apple alone made that contribution, think what the others can do.

The point being that if the loss rate is 12 percent or maybe even 15 percent, if that is the risk that Congress is willing to accept, the program still pays for itself in taxes and job creation.

There are many reasons for the currently high default rate. We do not know all of the answers. Some of them are the high cost of leverage. In the early 1980s, as you will recall, we had debentures that cost us 15.5 percent, 10-year fixed interest rates with very high prepayment penalties. There have been a dearth of equity offerings in the recent 5 years since the mid-1980's. Perhaps there are too many people in the program that should not be there, as it grew rapidly in the mid-1980's.

For example, this happened in the last 1960's, as you will recall. There were many new licensees in the early 1960's when the pro-

gram became operational, and there were many that went out of the program in the late 1960's when they figured out what it was all about.

There has been a very competitive marketplace with non-SBIC venture capital firms when they grew in the mid-1980's. They are now shrinking in numbers and in dollars. But during the period of the mid-1980's, they forced a lot of nonyielding equity only deals upon the industry. I will discuss this later in our debt to equity comments.

But those deals were somewhat different from the historical role of a lot of SBIC-type deals. By that I mean a deal with a yield and a spread and some equity kicker. The competitive marketplace made that hard to come by in the mid-1980's.

We do know that the current default rates are not a result of valuation or accounting issues. That is merely a symptom of the problem. We would like to know more about the defaults as an industry, so that we can hopefully learn lessons from the past.

We proposed that a study be performed by a major independent firm to be paid for out of some of the SBIC user fees which they collect on the leverage that we borrow. This request was denied. We stand ready as in industry to work with some independent universities, and stand ready to help the SBA, and would like to do so in analyzing some of the reasons for defaults.

We think that it is prudent to understand better what the real reasons are before we go out and enact regulations which may have no meaning. For example, some of the basic data could be instructive, such as what was the average tenure or experience level of the SBIC manager? What was the average age of the deals that the SBIC made that went into default? What were the type of investments, equity or debt?

There is a lot of basic data which we think could be easily and inexpensively accumulated if we had access to it. We cannot get ourselves because it is privileged and confidential. It could form a data base just to look at to see if there are any lessons to be learned. If there are lessons to be learned, then maybe we can do something about it.

The next point that I will address is the decline in the number of licensees and the decline in the use of leverage. I am not going to go into the statistics which are described in our written testimony and which you know very well about the decrease in the number of licensees and the decrease in the use of leverage.

One of the reasons for the decrease in licensees we feel probably was the dramatic increase in pension funds, and insurance companies and large corporations entering the venture capital and LBO industry during the period of 1983 through 1987.

The number of new dollars coming into the so-called venture capital industry reached a high of $4.5 billion during that period a few years back. But this year, it is projected to decrease to under $1.4 billion. While it lasted, it was easier to raise venture capital dollars than it was to deal with the disorganized, nonresponsive, and understaffed SBA that was being abolished by the prior presidential administration.

This venture capital fad is fading, however, as I will get into later, and those trends are changing. But it was a reason for a de-

crease in the number of new licenses during the last half of the 1980's.

Obviously, the Reagan administration's attempt to abolish the SBA did not do much for attracting or keeping the better Government employees, as we discussed earlier. Attrition increased, dialogue decreased, and regulations got sporadic. As you well know, we at NASBIC spent many years and many dollars trying unsuccessfully to create COSBI for the very reasons that we are articulating here.

Another problem is what we would call SBA's micro managing of the program. This includes some of the dysfunctional regulations, regulations that concentrate on whether the cost of lending should be a half of a percent more, and always trying to increase the user fees which we realize that sometimes is dictated by OMB and not the SBA. But, just as important is the failure to make some of the necessary changes which would improve the regulatory environment. Correction of all of these things would help bring more people into the program.

We suggested to the SBA last fall nine major important changes in the regulations. We actually drafted the regulatory language so as to facilitate the process and help with the investment division's understaffing problem which we recognize. Nevertheless, we have been disappointed that thus far we have had little response from our initiative to change some of these rules.

Quite frankly, we have been disappointed in the recent publications as of last week for example, September 27, and the earlier one on audits. These new rules fail to address some of the major problems and concerns that we have raised, and certainly do not address some of them with methods that we would like to see implemented.

On the subject of decreasing leverage, which goes with the decreasing number of licensees, I would submit that there has been a definite change in the standards for approving leverage that has occurred in the past year or so. I realize that the SBA testified to the contrary, but what we know from anecdotal evidence from talking to our members is that that is just the case.

From our conversations, it appears investment division staff have computers, and they have coverage ratios, et cetera, et cetera. This whole approval process has only worsened as you would expect with the advent of the Senate hearings.

As further evidence, and Mr. Crusto mentioned this as being a positive—our industry would argue that it is a strong negative—that 65 to 80 percent of the SBIC's applying for leverage were scrubbed out during the last two fundings.

We have done what checking we can into this, and again we cannot get at the private confidential information and can only talk to our members who share it with us, but we do not find any good business reasons for the scrubouts. At best in most cases, we get technicalities. Someone over there needs to stand up and make some risky decisions and not deal in technicalities.

Also, with the decrease in new licensees that I mentioned earlier and for those reasons, you would expect the use of leverage to decline as the use of leverage generally follows 1 to 2 years the increase in licensees, as it takes that long for a licensee to invest his

capital. Prudently, the SBA should not grant leverage for awhile, because they need to see if a licensee can develop a credible investment track record.

An increasing part of our industry's capital comes from banks. For reasons mentioned above, banks do not borrow money in most cases. However, our own internal industry survey which we commissioned approximately 5 or 6 months ago indicates that there is a need for leverage in the $50 to $75 million each year for the next 5 years range for roll-over financing only.

Our same survey of our members indicated the need for approximately $100 to $150 million for new investments, again for each of those next 5 years. This again assumes that the SBA is willing to grant the leverage and that this industry is not attritioned to nothing.

On the subject of valuations and accounting issues, Mr. Chairman, as you know, the board of directors——

Chairman LAFALCE. Is this not the guts of the issue?

Mr. WILKINSON. Sir?

Chairman LAFALCE. Is this not the guts of the problem that we are talking about?

Mr. WILKINSON. The leverage or the valuation?

Chairman LAFALCE. The valuation.

Mr. WILKINSON. Again, I think that is a symptom and not the real problem. The board of directors and general partners have to value the portfolio, which I think the SBA recognizes. CPA's cannot set values. They can only opine that the board or the general partners have followed prudent valuation guidelines in good faith.

There has been a lot of talk that certain boards of certain SBIC's now in default did not do that. I do not know. That is not information that we are privileged to. But again I would argue that is the symptom of the disease and not the disease.

I would add that for small privately held securities that these corporate values are often very fragile, especially in the earlier years. Valuation is a very subjective process. There is no single method for determining value.

NASBIC and NAIC have proposed adoption of comprehensive valuation guidelines. A copy of that is enclosed in our testimony. These provide far more detail than we would prefer in trying to set specific standards for such a very subjective process.

On the subject of audits, as you know, the SBA has proposed that we follow generally accepted Government auditing standards. We would submit that that is unnecessary and is duplicative of the current work that the Inspector General is doing. It will also add an additional expense to SBIC's.

However, as the SBA appears predisposed to institute these GAS procedures, we would only ask that the process be done in an efficient manner, so as to minimize the added cost to the SBIC industry.

Specifically, the proposal that was promulgated in August proposed GAS audit procedures which would, number one, require financial audits, which is fine. That is what we have always had. Furthermore, they require compliance audits. However, at that time, no guidelines were promulgated for what regulations CPA's

should be looking at. Therefore, they were left totally in the dark as to decide what regulations are important and what are not.

We have asked the SBA to reconsider this and not adopt any kind of compliance audits until guidelines have been published. Furthermore, we have asked that at least they limit the compliance audits by independent CPA's to the so-called big six regulations, those that are established by statute.

On your question that you specifically asked us to address, and that was should SBIC's be making debt or equity investments, I would submit that it is the statutory intent of the legislation that SBIC's provide equity capital and long-term funds. So the short answer is both types of investment.

Historically, our industry has had a range of structures and focuses from straight stock with a nonyield return to straight debt with a high coupon and no equity, and all combinations in between. All formats have been successful and all formats have been unsuccessful for SBIC's.

The question is what are the desires and what are the needs for the small business concern and what are the desires and what are the needs for the SBIC. For example, there are some companies which would much rather pay a 25 percent current cash-on-cash yield. They would rather do that than give up one share of equity. On the other hand, there are concerns that cannot pay a cash yield, and they can only accept equity and are very happy to sell equity especially if it is in a minority position.

Those SBIC's using leverage certainly must maintain a current yield or attempt to provide for timely payments of debentures. Therefore, they have to attempt to match capital gains from the sale of their equity investments to the debt service required on debentures borrowed. This is a fact that has proven to be very difficult at times, and is one of the reasons historically for some of the defaults.

I would also respond that regardless of Congress' intention or the statute's intention, I can tell you what is happening now. From conversations that we have had with the investment division, and from the high-scrub out rate that we have seen in recent months on leverage applications, from other indicators, and from the proposed new regulation that came out last week that requires for discussion at least, new SBIC's to also have a backup guarantee in the event that the SBIC's cash flow does not exceed 20 percent of its debt service, it is clear that the SBA is adopting a cash flow lender mentality.

This is different from years past when leverage was available to roll over maturing debentures and also, quite honestly, to fund equity investments in small business concerns. It therefore appears to us that the SBA is adopting a formula-based, cash flow mentality, when in fact we should be backing risky promising and growing young companies. There may be better ways to solve this problem.

In summary, Mr. Chairman, I would just like to state that NASBIC has made recommendations for improvements of the programs which are detailed on page 18 of our testimony. Thank you very much for permitting us to make our comments known today.

[Mr. Wilkinson's statement may be found in the appendix.]

Chairman LAFALCE. Thank you very much, Mr. Wilkinson. Our next witness is Walter Threadgill, legislative chairman of the National Association of Investment Companies.

TESTIMONY OF WALTER L. THREADGILL, LEGISLATIVE CHAIRMAN, NATIONAL ASSOCIATION OF INVESTMENT CCMPANIES, AND PRESIDENT, MINORITY BROADCAST INVESTMENT CORPORATION, ACCOMPANIED BY JOANN PRICE, PRESIDENT

Mr. THREADGILL. Thank you, Mr. Chairman. Mr. Chairman, members of the committee, we have submitted full written testimony, and I will attempt to summarize for you today the testimony.

The National Association of Investment Companies appreciates this opportunity to appear before the House Small Business Committee to discuss and address a variety of issues concerning the financial health and viability of the specialized small business investment company industry.

I am Walter Threadgill, president of Minority Broadcast Investment Corporation located here in Washington, DC, and legislative chairman of the National Association of Investment Companies. I am accompanied today by Joann Price, president of the association.

I am pleased to have the opportunity to testify today and provide the minority venture capital perspective to your inquiry regarding the health of our industry. As a SSBIC executive for the past 10 years and owner/manager of my investment company for the past 5, I have been a part of the industry's evolution and growth.

The SSBIC's are particularly concerned with recent developments and proposals in the SBIC industry because they come at a time when we had hoped to launch into a new era of high growth and development. We have few companies being transferred to liquidation, and although the industry average is 24 percent, the percentage of specialized SBIC debentures which have been accelerated over the past 10 years due to liquidation is 12 percent.

Let me put that another way, Mr. Chairman, because it is very important that we take note of this. If we use the SBA's admitted recovery rate today in testimony of 40 percent and we net it against the experience of the SSBIC's, it looks like a realized projected loss ratio for the SSBIC's of something around 7.2 percent. That is the loss rate. I am using the percentage of 40 percent that was used today by the SBA officials in their testimony.

But if you take the 7.2 percent loss ratio when measured against some other numbers, one number is that the SBA provided $28 million to the SSBIC's this year. The SSBIC's invest in $148 million. We leveraged $296 million, and we made total financing of $444 million. That provided 1,254 financing over the country with revenues of $1.3 billion, with 16,300 employees, with $65 million in taxes, with $48 million in estimating payroll taxes, and total Government collections of $141 million. That when you measure all of that against the 7.2 projected 10-year rate loss, I think the benefits of the program speak for themselves.

While we are certainly not claiming to be perfect, our profitability and stability is better than it has ever been. Less than a year ago you led the fight to pass a bill which finally ended the leverage funding shortage this industry has experienced for so many years.

We believed we were finally going to achieve the growth and development we knew the industry was capable of doing.

Unfortunately, the current situation has once again cast a shadow on the industry, and at some point it appears even to threaten the continued existence of minority venture capital.

We are particularly concerned with the attitude expressed in the Small Business Administration's most recent set of regulatory proposals. We will be meeting with the agency to comment on the proposals in detail, but cannot help but be dismayed at such SBA statements as that made to justify the limitation of pension fund investment in SBIC's because, and I quote:

> SBA does not think that, for the purposes of the SBIC program, pension funds are suitable investors, or SBIC's suitable investments for pension funds, because pension funds need reliable and steady investment income. This need is incompatible with the venture capital mission of the SBIC program.

We were under the impression that Congress addressed the question of suitability of investments for pension funds when it passed ERISA. To have our agency of advocacy attempting to label us to an outside investor as an even higher risk than other eligible venture capital vehicles which are able to attract pension funds reflects an attitude that has us extremely concerned.

We are also concerned about proposals such as the recommendation by the independent contractor hired by the SBA which would require our companies to declare and pay dividends to the SBA before they would be eligible to receive leverage. This proposal was alluded to in the administrator's testimony today before the committee.

Mr. Chairman, the issue of dividend payments on our companies' preferred stock is one your committee worked hard to resolve less than a year ago. As you are aware, the management of many of our companies believe it is important to retain earnings to continue to strengthen their companies. Their private sector shareholders support this strategy, and have agreed to forego the declaration of dividends during this crucial stage. The public sector partner in the SBA, however, would prefer to force the company to declare and pay dividends. This would weaken the balance sheets of our companies at a time when we can least afford it.

The proposal which you spearheaded, and which was passed as part of the fiscal year 1990 authorization bill, would solve this stalemate. The new law authorizes the SBA to offer our investment companies the opportunity to repurchase their preferred stock at a discount. In this way, the SBA could recoup funds from the preferred stock at the same time our companies could potentially improve their balance sheets as a result of this discount.

The NAIC has been working with the Investment Division toward the implementation of our discount repurchase program prior to this year's end. We urge you to encourage the SBA to continue its progress on this program to strengthen our industry rather than forcing our companies to take action, such as the declaration and payment of dividends, which would, in fact, weaken our industry.

At our 20-year mark in 1990, the industry is healthier than it has ever been. Since 1970, we have invested over $1 billion in businesses owned by socially or economically disadvantaged entrepre-

neurs. We have traveled up the learning curve and our members are now the recognized experts in minority venture capital.

In fact, our industry represents an increasingly vital source of capital to the minority business community. At the same time we have increased our investments in minority businesses. Our capital sources have dried up. Blacks in particular have experienced this as their portion of SBA guaranteed loans has gone from $180 million in 1980, all the way down to $71 million in 1988. We are one of the few remaining sources dedicated to minority business financing.

In preparation for this hearing, the leadership of the NAIC small business investment companies, as well as NASBIC officers discussed in detail the issues that have been the subject of a series of hearings held by the Senate Small Business Committee. We discussed issues relating to valuation, to audits, to regulatory compliance, to licensing, as well as the SBA's program management. Our legislative committee as well as a task force of the board of directors developed recommendations designed to improve the overall management of the program and at the same time ensure, to the extent possible, that the Government's role as a creditor is adequately protected. We are pleased to present a documentation of recommendations agreed to by both associations to the committee. This document has been sent to Administrator Engeleiter for her review and consideration.

Through most of the congressional hearings, we have heard repeated testimony regarding the Government's exposure and the concern over potential losses of Government funds. We are confident that this industry-developed document, which is already followed by many investment companies, will ensure our company executives are utilizing a prudent approach in valuing their investment portfolios. Valuation appears part of the concern. We must also remember that there is a clear and profound difference between good valuation techniques and clear and apparent fraud. We have hope that our document, in terms of our model of the valuation of portfolios which has been submitted to the SBA and to our members, reaches the issues and concern of this committee and the SBA with respect to valuation techniques.

Our industry's experience has taught us many things, chief among which is the fact that the most important determination of an investment company's success is the talent of its investment executive. We believe that the licensing process should be modified to place more emphasis on this factor.

Currently, those interested in operating SSBIC's must complete a comprehensive application that includes the statement of need, the investment philosophy, the management plan, and the financial projects.

In 1984, the qualifications for managers were strengthened to include very specific business acumen. We collected operational documents, checklists, and other forms used by executives, investment executives from across the country, to help identify those which have proven to be the most useful and effective. These will be shared with the entire membership so that all of our companies will have the benefit of the best information available. This

manual will be distributed to our industry in 2 weeks, during our annual convention.

Mr. Chairman and members of the committee, it has been our pleasure to appear before you this morning. We feel that it is vital that this industry continue. You have been an ardent supporter of our industry and our program. We sincerely hope that when these oversight hearings are concluded, the industry will be stronger for having been through this process.

The next 20 years are crucial to the continued development of the minority venture capital industry. We have proven that we can successfully invest in specialized markets and make a return on that investment. We have assisted in the creation of wealth and witnessed the positive impact many of these companies have had on individual communities. We have developed the venture capital talent, the national network, the deal flow and the institutional and entrepreneurial relationships. The future need is the ability to convince institutional investors and pension funds that investing in minority venture capital is an essential part of the minority economic development strategy. Thank you, Mr. Chairman.

[Mr. Threadgill's statement may be found in the appendix.]

Chairman LAFALCE. Thank you very much. I would ask you, Mr. Threadgill, or Mr. Wilkinson, or Ms. Price or Mr. McNeish, we have heard a lot of different percentages—7 percent for you and somebody has talked about 2 percent, somebody has talked about 12.8 percent, somebody has talked about 28 percent. I am sure they are all accurate, but you have to almost stop and say just wait a minute now, what are you talking about here?

But it is all an emphasis on the downside that we have heard. Do you know what the default rate is, what the loss rate is, what the actual realized loss is, et cetera?

What about the upside? Is there any measurement that the SBA has or can have or that the industry has or can have to compare the benefits to the losses so we could try to see this in some type of perspective?

Nobody wants to lose $50 million, $100 million, $250 million, or $375 million. If all we are looking at are losses, forget it. But we are not just looking at losses. We are looking at a lot of gains here. Is there any way to measure the gains and compare them to the losses and the investment?

Mr. THREADGILL. Mr. Chairman, one of the things I tried to do in my testimony today, because there seems——

Chairman LAFALCE. Other than just anecdotal evidence. I mean, is there any way of quantifying this?

Mr. THREADGILL. I guess there is quantitative evidence and there is quantitative evidence. To the extent that one can look at a percentage loss rate, convert that loss rate into absolute dollars and measure those absolute dollars against investments and taxes paid and jobs created and businesses established, one has to then begin to strike the balance in terms of the——

Chairman LAFALCE. I know that, Mr. Threadgill. My question is has anybody attempted to do this statistically? Does SBA do it? Does the industry do it to come up with some kind of a cost/benefit ratio?

Mr. WILKINSON. As you recall, 10 years ago the industry did a study with the help of Arthur D. Little and Deloitte Haskins & Sells, as they were called then, that was based on some science and widely tallied for a number of years. That study showed that the industry provided a 100 to 1 benefit to cost ratio to the Federal Government. That information is quite dated. It is over 10 years old.

We at NASBIC, last year in fact, discussed in detail whether to try to update that or commission a new study. It is very expensive and we had spent a lot of resources on some of the materials for our COSBI legislation. But given the current events, we have made the decision that we are going to commission such a study. It will be down the road. It will not happen in the next 2 or 3 months because, by necessity, there is a lot of science involved. But that is one thing we are trying to do.

Chairman LAFALCE. All right; in order to enhance the credibility of that study, it might not be a bad idea to bounce off the methodology in advance not only to the committees of jurisdiction, but perhaps even to the GAO, et cetera, so that it might not look as if it is an industry-sponsored propaganda piece.

Mr. WILKINSON. That is a good point. One thing that we have discussed that is easier to do, that we think is relevant and which I alluded to in my testimony, is simply to look at 20 winners and what taxes they pay and look at what the SBIC licensees themselves have paid in taxes over the year. That methodology is not suspect. It is factual.

For example, I testified that Apple Computer alone paid $250 million in taxes last year. If you follow one projection of losses, and I will use the 8.5 percent over the $3 billion that had been loaned and some repaid, the aggregate loss was $250 million, and Apple alone paid for the entire program for 32 years. That was one——

Chairman LAFALCE. OK. You are in a business that is involved inherently in risk. If you were not involved in risk, there would be no reason for your existence.

Mr. WILKINSON. Or we are not doing our job.

Chairman LAFALCE. Or you are not doing your job, OK? But in order to sustain a governmental role with the private sector in the undertaking and sustaining of this risk and the bearing of the burden of the risk, I think we are going to have to come up with some way of quantifying the overall value of the program better than we have thus far. That is one point that I would make.

Another point that I would make is that nobody has a greater stake in being zealous whistle blowers on fraud or prosecutors of fraud than you the leaders of the industry associations, and nobody has a greater stake in ensuring sound management practices consistent with the carrying out of your mission, which is the undertaking of risk, than your industry. You know this, of course, but this was also true in the S&L industry, and they buried their heads in the sand and did everything possible to camouflage their problems rather than to admit, discuss, and cure the problems.

So, I do not have any reason to charge that you have not been zealous at all, but I just want to make that point and underscore its importance. You can be the best guardians of what is going on and what is going to be taking place.

Third, I do not know about Mr. Threadgill and Mr. Wilkinson, because I do not know them well, I do know that Ms. Price and Mr. McNeish have been around for a long time. Are things any worse right now than they were 20 years ago, 15 years ago, a decade ago, et cetera? Are they just a little bit worse, a little bit better, roughly the same but just getting a lot more attention now, or is it they were bad a long time ago and were corrected but we are just now bearing the burden of some of the problems? What is your analysis, any of the four of you? Ms. Price.

Ms. PRICE. I have been with the industry for 12 years, so I can speak to it from that perspective. But I can say from our side of the industry that in 1990, and maybe that is just luck on our part because you are looking at it closer at this point, our industry is healthier. It is clearly healthier by our default statistics.

Chairman LAFALCE. Healthier than what?

Ms. PRICE. It is healthier than it was in 1971, when it started. It is healthier than it was in 1980. It is healthier than it was in 1985. It is healthier by the profit statistics. It is healthier by the default statistics. It is healthier by the loss statistics, and those statistics are on the record. They were done—they are done every quarter by the——

Chairman LAFALCE. Do you have an appendices which tries to compare the health of your industry today in comparison with every year for the past 20 years?

Ms. PRICE. Yes; we have that. We have every official statistic that SBA has and we can give you an official analysis in fact period.

Chairman LAFALCE. OK, good.

Mr. Wilkinson or Mr. McNeish?

Mr. WILKINSON. I have been involved for 17 years, as I said before, and this industry seems to always have some problem. I do not think it is unlike any other governmental program. There is always some crisis to solve, some mountain to climb. For example, the ways of funding has changed over the years, first the FFB and now private sales. There always seems to be some regulations proposed that we think would be very detrimental to the industry and we try to change those.

The thing that concerns me the most is the publicity associated with all these other S&L and things which I would like to address separately in just a second. But the thing I have observed in the past 5 or 6 years is just the personnel situation at SBA. They were leaderless for a couple of years between Mr. Sanders and Ms. Engeleiter's arrival. There are far fewer people today than there were when I started in the program 15 years ago. The uncertainty of the abolishment of the program did not do much for keeping the best or attracting good people, and some of them left.

We are in a very subjective, inexact science. It takes a cooperative effort to want to make things happen. You cannot sit there and constantly be worrying about someone missing the last "t" of the regulation, and everything is going to go to hell and things like that. It takes a cooperative spirit on the part of the personnel. From that standpoint, I think things are worse than they have been since I have been involved in the program.

Can we rebuild it? I hope so. Is the attitude right over there? I hope so. Are we getting new people? I hope so. I would encourage them to try to work with us as people who have to live in this environment to make the program work. So, that is the thing that concerns me.

I cannot tell you whether the ultimate default rate will be 12.5 percent or 20 percent and whether it is actually better or worse than it has been historically. We can look at some of those numbers. I do not know what the statistics were between 1962 and 1969, which I alluded to earlier. But as I recall there were 600 and some SBIC's created in the early 1960's. Is that right, Pete? I do not remember the number.

Mr. MCNEISH. Over 1,000.

Mr. WILKINSON. About 400 or 500 of them got out of the program in the late 1960's. So percentage-wise in terms of number of licensees, I would say we are not as bad as we were in the late 1960's. Of course, the program has grown and survived very well since the late 1960's.

We did not have any equity markets in the early 1970's. We overcame that. We did not have any equity markets in the late 1980's. Hopefully, we will overcome that. These things affect the program.

But without the people that are willing to try to make it work and a cooperative attitude, it is tough. That is one of my concerns.

The second point I wanted to make is this S&L analogy that is always used, and one of the members of the committee was alluding to that earlier. He kept saying, how far is the hole, or how deep is the hole? How far are you going to go?

It strikes me that this is different from the S&L's in the following relation as I understand the S&L problem. The reason that the U.S. taxpayer and the Federal Government keep coming up with $50 billion, $150 billion, now $500 billion, or whatever the number is, on the S&L crisis, as I understand it is because the entity keeps bailing out the S&L's that are going to default because of this guarantee or this insurance program to depositors.

In the case of the SBIC industry, you know your downside. There is no guarantee. I mean, the investors lose all their capital before the Government loses anything, and the most the Government can lose is whatever is outstanding right now. So, if you think that tomorrow you shut the program down and you lose every penny, the answer is there is a $1.2 billion at risk, plus the other $500 million in liquidation. I do not think anybody believes if you shut the program down tomorrow you are going to lose $1.2 billion.

As I said earlier, I believe in previous testimony it was alleged that at least 85 percent of the SBIC's are in good shape. I do not know the exact number, and maybe we will know more with these valuations.

Chairman LAFALCE. I would like for you, Mr. Wilkinson and Mr. Threadgill, to come up with a question and answer format for me, a worst case scenario. So if the worst were to happen, you know, bing, bing, this is what would happen, and then come in also with a probable case scenario. We must have some way of dealing with the problem, but also understanding its scope and nature so that we do not create self-fulfilling prophesies, so we do not throw the

baby out with the bath water. That might be helpful. Did I interrupt you or were you finished?

Mr. WILKINSON. No; we will try to do that. We can run through some scenarios.

Chairman LAFALCE. Yes; OK, good.

Mr. WILKINSON. We are very concerned about the self-fulfilling prophesy also. We are a little bit like the pending recession which we keep wishing upon ourselves. If we say it long enough, we might have one.

Chairman LAFALCE. Yes.

Mr. WILKINSON. We do not want that to happen to our industry.

Chairman LAFALCE. OK, good. I had earlier asked Ms. Engeleiter a question about the proposed provisional budget agreement on tax incentives for small businesses. Does anybody here care to comment on that, or does anybody here feel they are able to speculate on it?

Mr. Threadgill, yes.

Mr. THREADGILL. I have two comments. The first is that it is my understanding and the details have not been released, that these special provisions would not apply to banks and investment companies and the like. If they did, there would certainly be a pass-through benefit to the SBIC with respect to current deduction for book purposes that would retain some cash flow in the company and would have positive benefits to the SBIC.

My second observation is that there was talk of enterprise zone and tying this money to targeted enterprise zones as well, and I think that that could have a very positive effect in some of the urban areas, and it could also bring down the risk profile to investment companies by taking advantage of deductibility of an investment in a time and era when equity capital is very, very dear.

Chairman LAFALCE. My question was would there be any benefit for an investment in an SBIC or NASBIC, or an investment by an SBIC or MESBIC. Would you be able to take a benefit because of your investments in other type of small businesses that would qualify?

Mr. THREADGILL. Yes; we would if there is not a provision embodied within the tax code that says that banks, finance companies, and investment companies are ineligible to take this deduction. I believe I read, and it is very, very skimpy information at this point in time, a provision that said that financial institutions were not going to be able to take advantage of it.

Mr. WILKINSON. Maybe a better way to say it is there may be a benefit for SBIC's if there were an exemption that permitted SBIC's to have this tax exclusion for investing. Once upon a time we did have certain tax incentives such as the exemption on dividends from corporate investments. We had 100 percent exemption. SBIC's have historically had certain special exemptions in the tax code.

So even if, as Mr. Threadgill says, the current leaning is that corporations—let us say that is the common word—cannot participate—perhaps if SBIC's were permitted to, it would be very beneficial.

Mr. MCNEISH. To the extent, Mr. Chairman, if you are able to persuade the chairman of the Ways and Means Committee to favorably look upon that concept, we would appreciate it.

Chairman LAFALCE. I am just very open on the whole question. I do not know that I would have proceeded in that manner, but if that is a decision that has been made, then you make the best of that decision, and I think it is.

Mr. MCNEISH. My understanding is that it is premature. Nobody knows what it is going to look like.

Chairman LAFALCE. Yes; I think so, too.

Mr. WILKINSON. A concern that has been raised already by some of our members, and which was addressed in the page 1, right-hand column of the Wall Street Journal today, is that it is going to be a syndicator's field day.

Chairman LAFALCE. Front page, right-hand column.

Mr. WILKINSON. Right.

Chairman LAFALCE. Yes; that is my biggest concern.

Mr. WILKINSON. We have the same concern, because we will be the ones that it haunts 5 years down the road. So we have that same concern, but we would like it structured so it would benefit small business.

Chairman LAFALCE. Yes; if this is just a syndicator's delight, forget it. What a price to pay for giving up, or giving the President something like capital gains, other than what we had requested. All right, thank you very, very much.

The Small Business Committee will adjourn, although we will be revisiting this issue again in the near future. I do not think we will have another hearing in this Congress, but I am sure that we will be revisiting it early in 1991. Thank you.

[Whereupon, at 12:35 p.m., the committee was adjourned subject to the call of the Chair.]

APPENDIX

OPENING STATEMENT
HONORABLE JOHN J. LaFALCE

HEARING ON
SMALL BUSINESS INVESTMENT COMPANY
&
SPECIALIZED SMALL BUSINESS INVESTMENT COMPANY PROGRAMS
October 2, 1990
10:00 a.m.

Today we are examining the investment company programs through which private companies, licensed by the Small Business Administration, provide venture capital to small businesses. These SBA licensees are called Small Business Investment Companies or SBICs unless they specialize in providing assistance to minorities, in which case they are called Minority Enterprise SBICs or Specialized Small Business Investment Companies.

The investment company program is authorized in the Small Business Investment Act of 1958, and for 25 years has been viewed as a shining example of public/private sector partnership.

During those years, the loss rate to the government was almost nonexistent. In addition, if we take into account the additional taxes paid by firms assisted by the investment company program, it is clear that it is a real winner.

Success stories have abounded: there are SBIC stars such as Federal Express, Apple Computer and Cray Research, and MESBIC stars such as Essence Magazine.

More important, however, are the less than sensational businesses which have been started with the help of the investment company program -- simply good, solid small businesses which create jobs and support our economy. These are the real success stories of the investment company program which has supplied capital of $9 billion.

However, beginning about five years ago, something happened -- the number of SBICs began declining as licenses were being surrendered and new applicants were not coming along to take their place. At the same time, requests for leverage or SBA money from the SBICs also began declining.

Various reasons have been offered for this and maybe there is some validity to all of them.

Some have argued that the 1986 tax reform act reduced incentives for investments.

Some have argued that the agency was guilty of over-regulation.

Some have argued that it was uncertainly over the existence of the SBA.

Others have argued that it was simply the economy and the stock market uncertainty.

Whatever the reason, this year three multi-million dollar SBIC losses have been announced.

Almost overnight the program seemed to be going from a stellar performer which other countries wanted to replicate to one which should never have been founded.

Some cried that this was another savings and loan crisis and projected losses of $300, $400 or even $500 million.

In June, SBA responded by freezing new entries into the program.

The Inspector General's staff fanned out to examine SBICs.

SBA personnel were shuffled.

It is now been almost three months since these actions were initiated. I am pleased to note that disaster has not struck and hopefully it will not.

Today we have asked Administrator Engeleiter to appear before the Committee. The questions are many fold:

- What happened?
- How did the agency respond to not only protect the government's interest but also to help the program?
- What are the latest steps the Agency has taken in proposed rules, published late last week, and why?
- Are there future Administration actions to be taken?

I want to note my personal concern about the direction of this program -- and particularly with some of the doomsday stories which have been told -- but, I do not believe that this venture capital program is doing as poorly as some suggest. It may be that it can be improved as is true of almost any program. It may need legislation, and, if so, I am prepared to consider it

at the earliest possible date, and I look forward to the Administrator's input on this.

I have every confidence that the Administrator will tell us all of this and more, and then we will turn to the industry representatives who are here today to present their views: Mr. Walter Wilkinson, Chairman, of the National Association of Small Business Investment Companies and Mr. Walter L. Threadgill, Legislative Chairman of the National Association of Investment Companies.

Before we ask Administrator Engeleiter to come forward do other Members have an opening statement?

Statement of the Honorable Joseph M. McDade
Vice Chairman
Committee on Small Business
U.S. House of Representatives
October 2, 1990

Mr. Chairman, I commend you for holding today's hearing to examine problems in the SBIC program.

The SBIC program has been the pride of the SBA since its creation in 1958. Corporate giants such as Federal Express, Cray Research and Apple Computer, to name only a few, received early infusions of seed capital to launch them. I am deeply troubled by the unprecedented number of defaults that have plagued the program and am eager to ascertain how these defaults came about.

It is important that we get at the root causes of the program's problems and undertake corrective action to rid the program of its weaknesses.

I have long been a staunch supporter of the SBIC program, because I believe it provides the capital that many small firms need to begin and expand.

I would like to welcome our witnesses, and I look forward to hearing their testimony.

SILVIO O. CONTE
FIRST DISTRICT, MASSACHUSETTS

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PROCUREMENT, TOURISM, AND RURAL DEVELOPMENT

MIGRATORY BIRD
CONSERVATION COMMISSION

BOARD OF REGENTS
SMITHSONIAN INSTITUTION

WASHINGTON ADDRESS:
2300 RAYBURN OFFICE BUILDING
WASHINGTON, DC 20515
PHONE: 202-225-5335

DISTRICT OFFICES:
FEDERAL BUILDING
78 CENTER STREET
PITTSFIELD, MA 01201
PHONE: 413-442-0946

187 HIGH STREET
HOLYOKE, MA 01040
PHONE: 413-532-7010

Congress of the United States
House of Representatives
Washington, DC 20515

Remarks of the
Honorable Silvio O. Conte
Committee on Small Business
Hearing on
Small Business Investment Companies

October 2, 1990

Thank you, Mr. Chairman. Thank you for calling this hearing on an issue that could have a profound effect on the availability of venture capital for small businesses all across the country. Small Business Investment Companies have achieved an excellent record of fostering the foundation and growth of small businesses in all sectors of the economy. The names of the major firms that got start-up help from SBICs reads like a list of America's best and brightest business successes.

Unfortunately, there have been some grave problems over the last few years. Losses in the program have climbed to over $500 million dollars and involve over 170 SBICs. This is staggering amount which has the potential, if unchecked, to swamp the whole program.

I look forward to hearing from the distinguished witnesses before us today. In particular, the testimony of the honorable Susan Engeleiter, the Administrator of the Small Business Administration. I hope they can shed some light on ways to aid this valuable program. Thank you.

OPENING STATEMENT OF THE HONORABLE JAMES H. BILBRAY

COMMITTEE ON SMALL BUSINESS

FOR THE HEARING ON SMALL BUSINESS INVESTMENT COMPANY PROGRAM

October 2, 1990

I would like to thank Chairman LaFalce for calling today's hearing.

It is a fundamental service of our Committee to oversee and guide the Small Business Administration. We are aware of the importance and the innovation of the SBA's programs providing small businesses the opportunity to develop and expand in today's increasingly competitive financial environment.

I have always been a strong supporter of the Small Business Investment Company Program. Over the past twenty years enabling small businesses to obtain start up and growth capital, otherwise unobtainable through the standard banking and financial channels, the SBICs have helped to fill a great gap buttressing the endeavors of a great many hard working entrepreneurs. Giving individuals the financial break necessary to succeed, the SBIC program has been a catalyst for injecting bursts of economic growth into our economy. To stimulate and revitalize the small business sector of our economy, these programs, administered by the SBA, are fundamental to the growth of the economy.

With much attention focused on our current efforts to resolve the fiscal insolvency precipitated by the S&L crisis, I am greatful to the Chairman for his foresight to investigate the management of the SBIC program. It has become all too evident that lacking a clearly defined warning policy has the potential effect of placing the administrators of the SBICs in as vulnerable a position as the bank regulators may soon find themselves. Our role as legislators is to work with you to ensure the safety and soundness of our lending programs.

I look forward to hearing from all of our witnesses today, and again I thank the chairman for calling today's hearing.

OPENING STATEMENT OF HON. ESTEBAN EDWARD TORRES

Mr. Chairman, I want to commend you for holding this very important hearing on Small Business Investment Companies.

Small Business Investment Companies play a major role in our economy. They are the fuel of the economic engine, which creates jobs, and they are the spark plug which allows for institutional investors to invest in America. Every dollar invested in Small Business Investment Companies is an additional two dollars in bank or institutional financing for structured deals.

Today's hearing is an opportunity for witnesses to tell us how we can improve the Small Business Investment Company program. This industry has compiled an impressive track record on creating new businesses. Therefore, we must work together on exploring new solutions to the problems of licensing and auditing requirements.

Thank you.

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF THE ADMINISTRATOR

TESTIMONY OF

SUSAN ENGELEITER

ADMINISTRATOR

U.S. SMALL BUSINESS ADMINISTRATION

BEFORE THE COMMITTEE ON SMALL BUSINESS

OF THE U.S. HOUSE OF REPRESENTATIVES

ON THE SMALL BUSINESS INVESTMENT COMPANY PROGRAM

OCTOBER 2, 1990

Mr. Chairman and distinguished members of the committee, it is a pleasure to testify before you today as Administrator of the U.S. Small Business Administration (SBA). I am accompanied by Mr. Mitchell F. Crusto, Associate Deputy Administrator for Finance, Investment and Procurement; Ms. Sally Narey, the General Counsel; and Mr. Joseph L. Newell, Director, Office of Investment.

I. OVERVIEW

Since taking up my official duties at the SBA on April 20 of last year, I have had the opportunity to become increasingly aware of the important and innovative role SBA's programs play in assisting small businesses to start up, expand and survive in an increasingly competitive financial environment. SBA's programs are especially needed at this time, when small businesses are faced with a more intense need for access to capital. It is the availability of capital that can make the difference between success and failure for small businesses and the people they employ.

You have asked me to address one of these programs -- the Small Business Investment Company (SBIC) program. Mr. Chairman, I appreciate the attention that is being given to the improvements that must be made in the management of the SBIC program. It has been a number of years since either of the oversight committees

or previous SBA Administrators have thoroughly reviewed this program. I consider us allies in correcting the problems that have developed.

I would like to begin by making some overall comments on the SBIC program. Clearly it is a program intended to fill an unmet need. The mission of SBICs is to help America's small businesses obtain start-up and growth capital they usually cannot obtain from banks and other financial institutions. SBICs are fulfilling that mission and the need for the program remains strong.

Unfortunately, however, the program has problems. These problems go to the fundamental nature of the program and the Government's regulation of the SBIC industry.

First, problems stem from the inherent risk involved in investing in small businesses. This is a high risk program, and sizable dollars are at stake. Congress must determine what level of risk it is prepared to accept to achieve the program's mission.

Second, problems result from the present financial structure of the program. The program mainly encourages thinly capitalized SBICs to "leverage up" by borrowing Government funds to make equity investments in small businesses. The equity investments, like other types of stock, seldom offer immediate cash flow for the SBIC. This can result in an eventual cash flow crunch.

SBICs must generate enough immediate income to make interest payments on their Government "loans" and to cover overhead and operating expenses. This cash flow need can conflict with pure equity financing of small businesses.

Third, problems result from spotty Government oversight and supervision of the program. I believe that our present regulatory and supervisory framework is ineffective in monitoring and regulating the SBIC industry. This problem is in part due to cutbacks in staffing going back many years, and in part to a longstanding separation of program functions. Licensing, leveraging and programmatic regulation of active SBICs are assigned to the Investment Division, while regulatory audits/examinations are handled by the Inspector General, and the liquidation of defunct SBICs is handled by the Office of Portfolio Management. Thus, no one office has full oversight of the program.

II. BACKGROUND

To understand the issues involved with SBICs and their regulation, it is important to be aware of the program's background. The SBIC program, created by the Small Business Investment Act of 1958, stimulates and supplements the flow of private capital to both newly formed and existing small businesses. These businesses use the capital to finance

operations, growth, expansion and modernization. In addition to regular SBICs, there are Specialized SBICs, or "MESBICs", statutorily dedicated to assisting small businesses owned by socially or economically disadvantaged Americans, mainly members of minority groups.

As you are aware, the concept behind SBICs is to utilize the expertise of private sector venture capitalists, encourage them to raise private capital to invest in small business, and provide a vehicle to raise additional funds. The funding mechanism generally involves SBA guarantees of SBIC debentures issued to the investing public.

I regard SBICs and the SBA as a positive private-public partnership to assist small and minority businesses. The SBIC program has produced almost $9 billion in public and private capital investments in America's small businesses. The SBA has provided about $3 billion of that total. Many major firms, including some that have become household names, have benefitted from early infusions of SBIC financing, including Apple Computer, Federal Express, Midway Airlines, Cray Research, Intel, Pandick Press, Rolm Corporation, Teledyne and Financial News Network.

Taxpayers have also benefitted. During fiscal year 1989, the active SBICs paid $58 million in income taxes. Small businesses financed by SBICs pay many times more in federal, state and local

taxes.

SBICs already are governed by a number of requirements meant to ensure their integrity. Until now, the minimum private capital needed for licensing an SBIC was $1 million. Each SBIC must have a manager who has at least five years of successful business investing or commercial lending experience.

An applicant must submit to SBA an acceptable business plan showing the need for the proposed SBIC and the way in which the applicant will meet that need in a manner consistent with the program's purpose and regulations. Applicants must provide income and expense projections that appear achievable for the amount and type of small business investments contemplated, and they must demonstrate a likelihood of financially successful operations. Once licensed, an SBIC is subject to program regulations which prohibit the following:

1) Conflicts of interest and self-dealing;
2) Over-concentration of financing in any one small business;
3) Financing of businesses that do not qualify as small. In the case of a Specialized SBIC, small concerns must also be owned and controlled by a disadvantaged person;
4) Charging excessive interest and fees on small business financings;

5) Acquiring control of a small concern except where necessary to protect the SBIC's investment, and with required SBA approval; and

6) Financing rental income properties, speculative stock investing, or other activities not consistent with statute and regulations.

Licensees are subject to biennial compliance examinations performed by SBA's Inspector General (IG) and must submit annual audited financial reports to the SBA.

III. PROBLEMS AND ACTIONS

However, it is now clear that these requirements have not done the job. Shortly after becoming Administrator, I received a report from the Office of the Inspector General on an SBIC examination which the IG had started in early 1988. The report raised questions about the liquidation of an SBIC, Royal Business Funds Corporation. Upon receiving the report on August 18, 1989, I established a senior management task force headed by the Deputy Administrator to review the problems identified by the IG.

This initial study has set in motion additional reviews and findings that have focused on two broad areas: operation of the SBIC program and SBIC liquidation. First, I would like to describe the actions we are taking in regard to program

operations.

As result of our reviews, it became clear that:

1) We did not have a clear picture of the current financial status of the industry;
2) Our SBIC oversight was unnecessarily split between agency units;
3) Our regulations did not prevent abuses and straying from the basic purpose of the program;
4) We were understaffed for the needed oversight job; and
5) There was an undue risk of loss to the Government without sufficient financial safeguards.

We are now taking actions designed to strengthen program oversight and internal controls, reevaluating our regulatory policies and assessing our staffing needs.

1) We have made changes in the management of the program. We have installed as Associate Administrator for Investment one of our most seasoned career professionals, Mr. Bernard Kulik; we have added five new positions to the Investment Division; and we are conducting a review to determine a level of resources and staffing sufficient to cover improved analysis and oversight, on-site reviews, and more thorough evaluation reviews.

Historically, our resources have diminished as our responsibilities have grown. In years past when we had a much more simple and unsophisticated SBIC program in terms of statutory requirements and the amount of government leverage than we have now, we had more personnel in the Investment Division. The current program, which includes 383 active SBICs (and 39 pending license applications) and $1.1 billion in Federal exposure, is managed by just 29 people, not including the 5 positions recently added.

2) We imposed a 90-day moratorium on issuing new SBIC licenses, which terminated on September 29, 1990. Although we continued to accept and process applications, no licenses were issued during the period. We took the opportunity to do a preliminary review of the then existing licensing requirements and determined that changes were needed in the areas of minimum capital and management. The new requirements were published in the Federal Register in the form of interim final regulations. Licensing for those applications now with SBA is proceeding. The new licensing requirements will be effective only for applications filed on or after the effective date of the publication of the new requirements in the Federal

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Register. However, we are still reviewing the overall licensing requirements with the assistance of the Private Sector Council, and may recommend additional modifications as a result of that review.

3) We have proposed some regulatory changes and are prepared to issue more. Because of the number of proposed changes and their varying complexity, they are being prepared and will be published for comment serially. Each proposal has to receive OMB clearance before publication.

The first proposal published for comment is to adopt government auditing standards for the SBIC audits by independent public accountants, as recommended by the Government Accounting Office. The change will result in getting additional, separate reports from the SBIC's independent public accountant covering the SBIC's internal controls and its regulatory compliance. These reports should materially assist the Agency in its oversight role.

The next package, which was published in the Federal Register on September 27, 1990, contains 15 proposed revisions covering areas such as limitations on Government debt subordination, requirements for

financial statements from small business concerns, limitations on leveraged buy outs, and limitations on the placement of idle funds.

On the same date, another proposal, which clarifies the portfolio review requirements for independent public accountants (IPA), was published in the Federal Register. The proposal would require that the IPA determine that the information relied on by the SBIC in its valuation was appropriate for the investment in question and that the valuation is reasonable in view of the information relied on by the SBIC. This is not intended to make the IPA an appraiser or to substitute the opinion of the IPA, or, for that matter, of SBA, for that of the SBIC. It is intended to act as a normal check on the operation of the SBIC by its independent, outside auditor. We are doing further work in connection with portfolio valuation of SBICs.

Additional proposals are now under consideration. These include a revision of the size standards, a policy on the effect of delinquent preferred stock dividends on SBA leverage requests, and a definition of social or economic disadvantage for Specialized SBICs.

4) As required by statute, we have just completed an SBIC

funding. These fundings are offered to all SBICs but granted only to those in good standing. In fact, for the last funding, SBICs requested $77 million dollars in additional and rollover funding. After careful review of the financial material filed in support of these requests, SBA "scrubbed" the funding request down to $17.46 million, of which $8 million was rollover funding. After reviewing the funding criteria, we are now requesting that SBICs provide additional information concerning portfolio valuation for participation in the fundings.

The Agency has not changed its criteria for the approval of debentures. We are reviewing each request individually and making funding determinations based on all the appropriate credit factors involved. All SBICs, including Specialized SBICs are subject to the same reasonable credit analysis.

5) With respect to valuation problems, the IG has completed Phase I of his special study of SBIC evaluation and reported the findings of this study. We have reviewed the IG's draft report which details the valuation practices and problems of five SBICs. One SBIC appears to have no portfolio valuation problems.

A second SBIC is being carefully watched because of its financial weaknesses and that of its parent bank. A third SBIC, which has some questionable valuations but is not capitally impaired, has been asked to supply specific valuation information. A fourth SBIC was ordered to cure its probable impairment by September 30, 1990, or face liquidation action. A fifth SBIC has been placed in liquidation status.

6) Phase II of the IG study involves "on-site" examination of certain SBICs, in coordination with the Investment Division, and is now underway. This will be completed shortly and evaluated for appropriate action based on the material found in these visits.

7) In addition to the IG's special study, at the request of the Investment Division, an outside contractor has completed a valuation study of a related group of SBICs. As a result of the review of this group, the financial statements of the SBICs are being recast to meet our requirements and will be subject to further review. Also, our review of the operation of the group is continuing, and appropriate action will be taken.

8) For the SBICs not covered by these on-site visits, the Investment Division required each SBIC to respond to a

one-time financial and regulatory analysis disclosure statement which gives us current details of the status of every SBIC, its portfolio, and accounting practices as of June 30, 1990. These reports are being evaluated.

9) We are contemplating a major study of the value of the portfolio of all SBICs with Federal leverage. In that way, we will be able to get an appreciation of the financial health of the SBICs and be able to better estimate the problem areas we will have to face and the magnitude of those problems.

10) The IG is concentrating on the responsibilities of the SBICs' independent public accountants. An expert in audit quality control has recently joined the IG's staff. As a result, we believe appropriate action will be forthcoming shortly.

Our basic purpose in taking these steps is not to injure the program, but to enhance its success. Our goals are to improve the Agency's ability to detect problems early, to develop solutions in a timely manner, and to substantially improve the efficiency of operating procedures in the SBIC program.

You asked that we comment on the use of available leverage by the

Specialized SBICs. This year, much of the funding available will not be utilized. This is true with respect to both SBICs and Specialized SBICs. There is no ready explanation for this. We have publicized the availability of the funds to both groups. Also, we have enlisted the support of both industry trade associations, and I know that they have given the availability of funding prominent publicity. Perhaps the hesitation results from unanswered questions about the state of the economy and the effect of the current international crises. We can assure you, however, that no proper request for funding from an SBIC with a satisfactory credit record and prospects, has been denied.

IV. LIQUIDATION PROCESS

As I mentioned a moment ago, our second major area of concern is the SBIC liquidation process. We have found the liquidation process inadequate to protect the taxpayers' interests.

SBICs can be placed in "liquidation" for a variety of reasons. Historically, more than half were placed in liquidation because of "capital impairment", which occurs when an SBIC's private capital is diminished by 50 percent (75 percent for Specialized SBICs). Other reasons for placing SBICs in liquidation include defaults on principal or interest payments to the SBA, and violations of regulations governing their investments. When an

SBIC goes into liquidation, the SBA pays the debenture holder. The SBA then acts to maximize the recovery of funds of an SBIC in liquidation. These actions range from litigation, to negotiated settlement agreements, to unconditional transfers of the company's assets to the SBA.

As result of our review it became clear that:

1) The backlog of SBIC cases in liquidation had grown to over 170, owing over $500 million to SBA;
2) There were only five staff members available to handle these cases;
3) There were substantial amounts of cash idle in a number of these cases;
4) There were insufficient controls in place in the handling of SBIC liquidations;
5) Senior management was not involved in major liquidation decisions involving millions of dollars;
6) As cases entered liquidation, assets were taken in at the value set by SBIC management rather than attempting to determine their true current value for the purpose of assessing potential recovery or booking current loss.

A discussion of SBIC liquidation problems must also include staffing considerations. The staffing profile of the SBIC

liquidation and portfolio management section over the last decade has been skeletal at best and, due to budget constraints, has failed to keep pace with increased activity, both in numbers and complexity of cases.

From 1980 through 1989, SBA averaged two to three full-time employees on its SBIC liquidation staff with additional assistance from the Office of General Counsel and six outside contractors in receivership cases. In 1980, the liquidation portfolio was at $100 million. By 1989, the portfolio had grown steadily in size to almost $500 million, while the staffing by that year only grew to five full-time employees. In recognizing this problem, I submitted to the Office of Management and Budget (OMB) a request for Fiscal 1991 -- seven new full-time employees will be added to this function. Five of these are already on-board.

The contractor study I mentioned earlier compared SBA's liquidation staffing level with that of other financial entities such as the FDIC and commercial banks. The contractor concluded that to come up to industry standards, SBA needed additional employees in its liquidation section, plus increased usage of contract receivership agents. Industry standards are $10 million per portfolio liquidator. Under this standard we would need additional staff to supplement those currently on board and the assistance we receive from the Office of General Counsel and the

contract receivership agents. The Office of Management and Budget has offered to review any request to increase personnel and we will be working with them to find a solution to this issue.

In addition, many of the salaries offered at other agencies (e.g. FDIC, Resolution Trust Corporation, Office of Thrift Supervision, etc.) for comparable financial and specialist positions are often at least one grade higher than those at SBA, which obviously makes recruitment and retention very difficult. In saving a few thousand dollars in salaries offered to these qualified employees, we may be losing millions in uncollected Government funds. Still, we continue to make a great deal of progress despite an overworked and underpaid staff.

There has been an upturn in SBIC defaults since 1985. From an average of 13 annually in the five years ending on Sept. 30, 1985, the number of SBICs placed in "liquidation" annually has doubled to an average of 26 over the last five years. Most disturbing are the size and complexity of SBICs going into liquidation in the latter period. The two largest liquidations in the history of the program occurred in the last year.

The SBIC program is perhaps subject to more risk factors than many venture capital firms, because SBIC investments are limited to small business deals. Since the program's inception in 1958,

470 SBICs have been placed in liquidation out of a total of 1,597 SBICs licensed. Since 1958, the SBA has made $600 million in payments to SBA-guaranteed debenture holders. During the same period, SBICs defaulted on $100 million in direct "preferred stock" outlays.

There are many factors that may have caused or accelerated this trend, including:

a) the "bursting" of the high-technology investment bubble of the late 1970s and early 1980s;

b) the 1987 stock market collapse, which depressed stock prices and seriously limited opportunities for taking young start-up companies public at favorable stock prices; and

c) greater competition from other capital sources for fewer good deals with sufficiently high return on investment potential.

d) the weakening of the real estate market in many parts of the country that make recovery on collateral in foreclosure cases more difficult and questionable.

As of September 15, 1990, we have taken the following actions:

1) In 1990 SBA has recovered over $25 million, closed out 28 SBIC liquidation cases and written off $30 million as uncollectible. Twenty additional cases totalling $76 million are targeted for resolution by the end of

the calendar year.

2) Identified cases in which SBICs in receivership have excess cash in their accounts and moved, where appropriate, to have the excess cash transferred to the SBA. We are actively pursuing these claims through the courts and in one case have collected over $1 million in cash.

3) Completed liquidation plans on a majority of the SBICs in active receivership proceedings.

4) Revised liquidation plans for five SBICs that have not complied with their existing settlement agreements.

5) Implemented revised procedures to independently value the assets of SBICs that are in liquidation and the assets acquired from failed SBICs that voluntarily assign their assets to the SBA.

6) Revised internal accounting procedures to ensure that losses anticipated in liquidation proceedings be recognized immediately upon transfer of an SBIC's assets to the SBA.

7) Established new procedures to involve senior management in the liquidation process, including strengthened guidelines for approval of expenditures relating to the liquidation of acquired assets.

8) Developed and started implementing new operating procedures for SBICs in receivership. We have also restructured the office of SBIC liquidation.

9) Updated our liquidation procedures manual in draft form, with a final draft scheduled for the end of the calendar year.

V. CONCLUSION

In summary, the purpose of all of the actions taken thus far is to make the SBIC program more effective and efficient and less costly to the Government. SBICs have been and will continue to be a source of capital so desperately needed at this time by small businesses. But without question, the program needs thorough review and correction of its problems. As I have testified, I began this review last year and it is continuing.

I want to thank the Chairman and the members of this Committee for your continued strong interest in the health of the SBIC program. I will count on your continued support as we make the decisions and take the steps necessary to correct the program's deficiencies. Some of these steps may involve legislative changes. I will, of course, keep you informed of our progress.

We have started by taking remedial steps that will limit the agency's vulnerability to financial losses by providing more efficient and timely identification and resolution of problems in the program. They will also provide less costly liquidations of

SBICs. These steps are essential to SBA's ability to minimize the Government's exposure from the program while continuing active Government encouragement for providing venture capital to small businesses.

I will be pleased to respond to any questions you may have.

October 2, 1990

STATEMENT OF
WALTER H. WILKINSON, JR.

Before the
COMMITTEE ON SMALL BUSINESS
UNITED STATES HOUSE OF REPRESENTATIVES

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

Good morning! I appreciate the opportunity to testify today at this oversight hearing on the SBIC program.

I am Walter Wilkinson, General Partner of Kitty Hawk Capital, Ltd., which is located in Charlotte, NC. I am testifying today in my capacity as Chairman of the National Association of Small Business Investment Companies (NASBIC), which is the national trade association for the SBIC industry. I am accompanied by Peter McNeish, President of the association.

I have been associated with the SBIC industry for 17 years. Our SBIC has private capital of $1.7 million and leverage of $3.0 million. Our SBIC invests in small businesses with outstanding prospects for growth. Over the past 5 years, along with our non-SBIC affiliate, we have invested over $10 million in small business throughout the Southeast.

THE ISSUES IN PERSPECTIVE

Mr. Chairman, recent oversight hearings in the Senate and related press coverage have raised several important questions concerning the management of the SBIC program and the health of the SBIC industry, and I intend to address those issues. At the outset I would like to take a few minutes to put the issues in perspective and place several facts in the record.

- **SBICs Finance Risky Ventures** - First, it is important to understand the nature of our business. SBICs are designed to finance high-risk, non-bankable, ventures. Inherent in that concept is the fact that some of those investments will not be successful - and there will be losses. A well-managed SBIC, with sound investment standards, good timing, proper market conditions and perhaps a little luck - will invest in enough winners to offset those losses, producing a net gain for the SBIC and its investors.

- **Private Capital At Risk** - The program is designed so that private investors who put their money in an SBIC are in the primary risk position. They stand to lose all of their invested capital before the government takes a loss. Even the most highly leveraged SBIC has private capital equal to at least 25% of its liabilities, and the ratio for most of the industry is even higher. This private capital cushion is far higher than that found in commercial banks or other financial institutions.

- **Benefits Produced** - The SBIC program has had a major, positive impact on the U.S. economy in terms of new company formations, job creation, innovations and the generation of new tax revenues.

We've testified previously about the numerous benefits that the SBIC program has produced, so I will not take the Committee's time by reiterating those achievements. Let me simply state, that the benefits by the program far outweigh any losses the government has realized to date or is projected to realize in the future.

• **Recent Notoriety About Defaults** - I would urge the Committee not to indict the entire SBIC industry because of two or three unusual default situations that have received a lot of recent notoriety in the press.

One of those cases was an SBIC that went into liquidation over 10-years ago, and involved questionable liquidation management practices by mid-level officials in SBA. The issue was whether those officials improperly managed SBA-acquired assets over the 10-year period after the SBIC went into liquidation. The SBA Administrator deserves credit for taking decisive action to correct the situation and to assure such practices will not be repeated.

The other case raised issues relating to: (1) valuation of assets, and (2) monitoring of the SBIC's financial performance. I will discuss valuations later in my testimony, but I would make a few general observations on SBA monitoring. First, it would be highly unusual for an SBIC - particularly one with a large, diversified investment portfolio - to literally collapse overnight. Normally, if individual companies in an SBIC's investment portfolio deteriorate, that deterioration takes time, and there should be adequate warning signs for both the SBIC's management and SBA.

The key question then is how SBA's monitoring system would allow the Agency to continue to put additional leverage into an SBIC over an extended period of several years without identifying the deteriorating condition of the SBIC and its portfolio. That monitoring system included several audits by the SBA Inspector General's office and reviews of the SBIC's financials by the Investment Division, both annually and prior to each leverage drawdown.

We understand SBA has taken steps to improve the process by which it monitors the financial condition and performance of SBICs, and we support any reasonable actions along those lines. As investors, we have a responsibility to monitor the performance of our portfolio companies, and SBA has a parallel responsibility with its portfolio of SBICs.

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• Misleading Press Coverage - One regretable spin-off of the Senate hearings has been a series of misleading and incorrect stories in the press that have unfairly damaged the SBIC industry. I have included as an attachment to my written statement a copy of our association's letter to the Editor of *Business Week* in an attempt to clarify the record.

• Moratorium on Licensing - Another negative result of the Senate hearings was SBA's imposition of a 90 day moratorium on the licensing of new SBICs. We strongly opposed a moratorium as a counterproductive action which was particularly unfair to the 37 companies who were in the application process, and a damaging setback that hurt both the industry and small business.

We were pleased to learn that SBA ended the moratorium late last week, and we hope the Agency will move quickly to license the proposed SBICs that have been stuck in the application process for the last 90 days.

BASIC ISSUES

Now let me turn to several basic points.

SBIC Investments - We're proud of our industry's outstanding track record. During the past 32 years, SBICs have invested $9.1 billion in 67,500 small businesses in all 50 states.

SBICs invest in start-up firms, recapitalize mature businesses and provide essential expansion financing for small growth companies. They finance diverse industries such as small manufacturing and service operations as well as high tech firms.

Highly successful "name brand" SBIC investments include Federal Express, Apple Computer, Rolm Corporation, Cray Research and Intel Corporation.

My company's portfolio does not contain such well known names, although we hope that some of our companies will be equally successful. I will mention examples of two recent investments we have made. FCR of Connecticut is a new, small company that is operating municipal recycling programs, and has a successful on-line operation in Charlotte, NC. Another company is Cardiovascular Diagnostics, Inc. of Research Park Triangle, NC, which has developed a quick method of analysing blood clotting features. Both of these companies have excellent prospects and they couldn't have developed to their current position without SBIC financing.

Overall Health of the Industry

• **Dramatic Decline** - Despite an excellent 25-year track record, the regular SBIC industry went through a wrenching decline during the last five years, from 1985-89, as shown by the following table:

	Active SBICs	# of Small Businesses Financed
1985	372	2,756
1986	333	2,675
1987	307	2,522
1988	285	2,227
1989	263	1,876

The number of regular SBICs today is almost 40% lower than it was five years ago, and the annual rate of small business financings has dropped by 30%.

A major factor in the industry's decline was the prior Administration's attempt to close down the SBA and terminate the SBIC program. The negative impact of that effort was compounded by a series of SBA regulations which have had a dysfunctional effect on the program. Those actions effectively

caused people to withdraw from the program and closed down the pipeline of new SBIC license applications, which historically have exceeded the loss of SBICs due to voluntary license surrenders or defaults.

Another important factor was the economics of the marketplace. Since the early 1980's, we have operated in an environment which provided larger companies attractive alternatives and continually expanding access to venture capital, leveraged buyout and bank financing. But these trends were not accompanied by similar opportunities for the types of small business served by SBICs.

Now we see those trends changing dramatically. LBOs and bank financing have dried up. Venture capital is in shorter supply. It is not surprising that we now see rekindled interest in the SBIC program. The cycle is changing. Pricing of SBIC investments should improve, resulting in improved performance of investments made during this cycle. Assuming a relatively stable economy this is the right time to expand the SBIC program, not contract it.

Renewed interest in SBICs began to emerge late last year when there was a significant increase in the number of new SBIC license applications. We attribute this turnaround, in part, to the new, responsive attitude of the current Administration, coupled with a major promotional campaign launched by our trade association to stimulate the formation of new SBICs.

Regretably, that renewed growth pattern has been severely curtailed as a result of the negative press coverage of the Senate hearings, the moratorium on licensing and the great unknown of how pending changes in SBA policies and regulations will affect the program.

• **Financial Condition of the SBIC Industry** - Based on the aggregate data available, and anecdotal information on individual companies, it appears that the remaining core group of regular SBICs is, for the most part,

essentially sound. SBA's ratings of operating SBICs confirm this conclusion, noting that 85% of those companies are in satisfactory or better condition.

The most recent financial data available for the SBIC industry on a composite basis is as of March 31, 1989. On that date, the 254 reporting SBICs presented a very strong balance sheet. In aggregate, those SBICs had total assets of $3.9 billion; total liabilities of $1.4 billion; and total capital of $2.5 billion. The industry's liabilities included $867 million in leverage from SBA. As you'll note from that data, on an aggregate basis the industry's debt to equity ratio is a very conservative 0.6:1.

Those SBICs were also profitable in 1989. Every category of SBIC, by ownership type, showed a profit during the year. On an aggregate basis, the 254 SBICs produced an 8.32% return on capital, and paid $56.2 million in taxes.

We do not, of course, have access to the financial records of individual SBICs, so we have no way of verifying the financial condition of individual companies.

Increase in SBIC Defaults - We are very concerned over the increased rate of SBIC defaults over the past several years.

There are several routes of departure from the SBIC program. A number of SBICs voluntarily leave the program each year for business reasons and surrender their license. An SBIC's license can be revoked - normally for serious violations of the regulations. Finally, an SBIC can be removed from the program and placed in "liquidation status": (a) because of capital impairment, which occurs when losses from bad investments cause an SBIC's private capital to diminish by 50% or more; or (b) for defaulting on payments of principal or interest owed to SBA. Since the program's inception in 1958, SBA has licensed 1,605 SBICs. Currently, 401 of those SBICs (25%) remain actively operating companies. Over the 32-year life of the program, 728 SBICs (45%) have

voluntarily surrendered their licenses; 7 licenses (0.4%) have been revoked; and 463 companies (29%) have been placed in liquidation by SBA. Once an SBIC is placed in liquidation, SBA takes action to recover its money by liquidating the SBIC's assets.

The causes of SBIC defaults are directly related to the risk and performance of the individual portfolio companies in an SBIC's investment portfolio, and the timing of that performance. Consequently, the causes are both varied and complex. It is a gross over-simplification to claim 20-20 hindsight and say the SBIC made "bad" investments.

To the best of our knowledge, no one has ever studied the underlying reasons for SBIC defaults, including a comprehensive analysis of the performance of their portfolio companies. Certainly, every SBIC manager believes each deal he or she puts on the books is "money good" at the time of the investment.

The are several general observations, however, that can be made about certain factors which can negatively affect the financial performance of SBICs:

- The quality of an SBIC's investment depends, in part, on the skill, experience and judgment of the SBIC's management. This observation relates to a point I will make on licensing standards later in my testimony.

- The slow-down in the high tech sector of the economy certainly had a negative effect, narrowing investment opportunities and pushing our smaller, marginal companies.

- The last seven years have been a very poor economic environment for the small growth company market. The diversion of major corporations to merger and leverage transactions, and the disappearance of an IPO market have virtually eliminated liquidity opportunities for small growth companies. At the same time, plentiful venture capital drove valuations up and returns down.

- Repeal of the capital gains tax exclusion was both a disincentive to the development of small growth companies, and a negative financial factor for SBIC investors.

- Finally, I would point to a series of dysfunctional SBA regulations that have had a negative impact on the industry, particularly those which have increased the operating costs of SBICs and narrowed their capacity to earn profits.

As a concluding statment of SBIC defaults, I would again stress the point that SBICs were intentionally designed to invest in small, but risky business ventures. Some of those small firms won't make it, and SBICs will have losses in their portfolios.

SBA Recoveries and Losses - There is one apparent misconception from the Senate hearings that should be corrected. On several occasions the amounts of money involved in SBIC defaults were incorrectly perceived as "losses" incurred by the government. In fact, SBA's actual losses from the SBIC program have only been a small percentage of total defaults.

SBA has provided $2.98 billion to the SBIC industry over the 32-year histery of the program.

Of that $2.98 billion:

- $1.3 billion (44%) has been repaid, with interest.

- $1.1 billion (37%) is currently being used by active SBICs

- Only $75 million (2.5%) has been written off as an actual, realized loss.

- The balance of $505 million (17%) is currently in liquidation, where SBA is seeking recoveries.

When an SBIC goes into liquidation, its private investors lose all their invested capital first, providing a buffer against government losses. In addition, many SBICs, prior to going into liquidation, have made a number of successful investments and those assets have substantial liquidation value.

SBA has had a 65% recovery rate. Over the life of the program, 463 SBICs (29%) have gone into liquidation. SBA has completed liquidation action on 306 SBICs which owed SBA $214 million. SBA recovered $139 million (65%) from the sale of those SBIC's assets.

SBA has charged off only $75 million in losses. In percentage terms, this means that **SBA's actual realized loss rate on the $2.98 billion it has provided to the industry is only 2.5%.**

The remaining 157 SBICs currently in liquidation owe SBA $505 million. If SBA's recovery rate experience is applied to this debt, it will produce recoveries of $328 million and losses of $177 million. On a projected basis, SBA's aggregate losses on all SBICs placed in liquidation to date would be $252 million.

That would translate to an effective loss rate of 8.5% on the total $2.98 billion extended to the industry.

Since Apple Computer paid $259 million in taxes last year, just one investee company could be construed to recover the total projected losses of the entire SBIC industry over 32 years.

AUDITS OF SBICs

One of the key issues being considered by SBA is the present system of SBIC audits, and how that system might be improved. In considering this subject, it is very important to make a clear distinction between financial audits on the one hand, and regulatory compliance audits on the other.

- Financial audits involve an audit of the financial books and records and financial condition of an SBIC. This form of audit is performed by independent CPA firms.

- Regulatory compliance audits involve an audit of the transactional books and records of the SBIC to determine that the SBIC has operated in compliance with SBA's regulations. Regulatory compliance audits are currently performed by the staff of the SBA Inspector General.

The SBIC Financial Audit - As a material part of SBA's responsibility to monitor the financial condition and performance of SBICs, each SBIC is required to submit an audited financial statement to the Agency on an annual basis, or more often if specifically required by SBA.

In addition to complying with AICPA financial audit standards, SBICs are required to comply with a comprehensive set of financial audit standards prescribed by SBA that are specifically tailored for SBICs. They are also required to use a special chart of accounts designed for SBICs and financial reporting forms prescribed by SBA.

To give you some idea of how detailed and comprehensive these requirements are, they take up 86 pages of fine print in the "U.S. Code of Federal Regulations."

In summary, the financial reporting requirements for SBICs are comprehensive and substantial. These requirements have been developed and revised on the basis of over 30 years experience with the SBIC program, and they provide extensive data which SBA can use to monitor the financial condition and performance of each SBIC.

Valuation of Portfolio Securities - The Senate hearings have made it clear, however, that even this extensive financial information may not be sufficient to give the SBA adequate comfort concerning the risk profile of individual SBICs or the industry as a whole.

One of the key factors in assessing the financial condition of an SBIC is the value of its portfolio company securities. And, the specific question is whether the process by which SBIC portfolio investments are valued and audited is reliable. It's a very legitimate issue, Mr. Chairman, and it bears a direct relationship to the overall health of the SBIC industry and the government's potential exposure to losses.

Let me first make some general comments about the valuation of SBIC portfolio investments. SBIC investments are generally venture-type investments in closely held, non-mature small firms whose stock has no public or private trading market. SBIC investments are not listed stocks, over-the-counter stocks or even pink sheet stocks.

As a result, determining the value of each investment is a very subjective process that depends on the circumstances of each individual financing, and requires an informed assessment of several non-financial considerations such as management capacity, market depth and product line breadth. This also means that there is no single method for determining the fair value of a very diverse universe of SBIC investments.

The accounting profession, a series of government agencies (including SEC and SBA) and the investment banking industry have long recognized that the responsibility for valuing portfolio securities in good faith should reside with the SBIC's Board of Directors or General Partner(s).

At the same time, both AICPA's and SBA's guidelines make it clear that the independent auditor's role is not to second-guess those valuations. Rather, the auditor's responsibility is to determine that the calculation process used by the Board was reasonable and properly documented.

This process has worked well for over 30 years. But, now it appears that while the basic concepts underlying the valuation process are sound and should be retained, the latitude allowed by the process does not provide the government sufficient comfort or certainty.

The SBIC industry recognizes that this issue of valuations is a reality that can be potentially disruptive for the industry unless it is resolved to the satisfaction of Congress and the SBA.

Consequently, I am pleased to advise you that the National Association of Small Business Investment Companies (NASBIC) and the National Association of Investment Companies (NAIC) have jointly taken the initiative to develop a set of "Guidelines for the Valuation of Portfolio Securities."

We've worked very hard on a joint-venture basis to develop these guidelines, Mr. Chairman. We assembled some of the best talent and brainpower in both the regular and specialized SBIC industries in a series of meetings over several months to hammer out specific standards for valuations.

We have jointly submitted these proposed guidelines to SBA with our recommendation that they be adopted by the Agency and uniformly applied to the SBIC industry.

A copy of the Guidelines is included as an enclosure to my written statement, and we would welcome any questions or comments from members of the Committee or staff.

These guidelines will not be without controversy in our own industry. They are far more detailed than many in the industry would prefer, and they set specific standards in an area that by its very nature is subjective.

In designing the guidelines, we had a threefold objective. First, we felt it was important to establish a conservative basis for determining the fair value of portfolio companies. Second, we wanted to develop a set of consistant valuation standards that the government can rely on. And, finally, we wanted to provide the certainty of a uniform audit process to verify the reasonableness of the licensee's valuations and the adequacy of its documentation. We feel confident that the adoption of the Guidelines by SBA will remove the cloud over the issue of valuations.

Regulatory Compliance Audits of SBICs

As I noted earlier, regulatory compliance audits involve an independent third-party review of the SBIC's operations to assure that the SBIC is in compliance with SBA's regulations. This type of audit includes everything from the mundane (is the SBIC license hanging on the wall?) to the sublime (does a complex financing involving several investment companies comply with the conflict of interest restrictions?). Regulatory compliance audits do not involve an assessment of the financial condition of an SBIC, nor do they deal with the value of an SBIC's portfolio investments.

Up until a year or so ago, the regulatory compliance audit process was fairly simple and responsibilities within SBA were well defined and understood by Agency personnel and by the industry. The IG's office provided an audit service, and the Investment Division had clear regulatory and enforcement authority.

Audit staff from the Inspector General's office conducted the onsite regulatory compliance audit of the SBIC and wrote an audit report which contained "findings of alleged regulatory violations" (if any). After review by the IG's central office staff, that report was sent to the Investment Division of SBA.

The Investment Division had the clear responsibility to review the report, determine if the findings of alleged violations were correct, seek additional information from the SBIC if necessary, and initiate and enforce any required corrective action. In short, the Investment Division had clear regulatory authority over the program.

However, within the past year this process has become very confused, and seemingly has been stood on its head. It appears that the Inspector General now asserts that his office has the authority to determine if regulatory violations have occurred, and the authority to stipulate what corrective action should be taken.

If this role reversal is allowed to take place, it will mean the Inspector General will be the regulatory authority in charge of the SBIC program, and the Investment Division will be reduced to the role of a paper servicing functionary.

This problem needs to be corrected. The confusion in this process has been disruptive, has caused great uncertainty in the SBIC industry and has resulted in delays in completing audits, which, in turn have delayed the funding of SBICs.

Applying Government Auditing Standards (GAS Audits) to SBICs

Now, on top of the confusion noted above, the SBA has proposed the application of government auditing standards to SBICs.

SBA's proposal to apply government auditing standards has two primary components, namely:

1. It incorporates the AICPA standards of reporting for financial audits. For SBICs, this is what is now being done by independent CPA firms, so it represents no change from the present system.

2. But, it would also add an audit component which covers "compliance with applicable laws and regulations." This is the exact function currently being performed by the Inspector General's audit staff.

Mr. Chairman, we have substantial problems with this proposal.

- First, we do not believe the audit of an SBIC's compliance with SBA's complex regulations is the proper role for the SBIC's CPA, whose primary expertise is in financial audits.

- Second, we believe the proposed regulation setting up this new system is materially flawed because it contains no guidance whatsoever for the scope or conduct of the CPA's audit. In effect, the CPA is left in the dark as to which laws or regulations are material and how they should be interpreted.

- Third, we object to the fact that this new CPA regulatory compliance audit will be an extremely expensive duplication of the Inspector General's statutory responsibility.

- Finally, we are seriously concerned with the very practical consideration of cost. It seems clear that if independent CPA firms are required to conduct audits of an SBIC's compliance with laws and regulations without specific guidelines, the cost would be enormous. And, the SBICs will be forced to pay for this expensive duplication - both the CPA and the Inspector General's compliance audits.

We have asked SBA to withdraw its proposed rule on government auditing standards, and reissue it only when a revised version contains specific guidelines for independent auditors. A copy of our comment letter on this proposed regulation has been submitted as part of my written testimony.

As I noted, we basically disagree with the concept of requiring CPA firms to conduct regulatory compliance audits. However, we understand that SBA is inflexible on this issue and will insist that this system be put in place. Acknowledging that reality, we would be pleased to work with SBA management and the Inspector General to see if a reasonable and efficient regulatory compliance audit system could be developed which would focus CPA reviews on the so-called "Big 6" regulatory violations.

Although we disagree with it, we can fully understand the Inspector General's desire to contract-out (or delegate) the SBIC regulatory compliance audit function to independent CPA firms and thereby free-up his limited staff and resources for other important audit functions within the Agency. However, we also believe that fairness dictates a need to resolve the very serious questions of audit scope, duplication and cost.

SBA's Management of the Program and the Relationship Between SBICs and the SBA

One item of interest to your Committee is SBA's management of the program. Obviously, Mr. Chairman, this is a delicate subject for a regulated industry to address. As you know, the Agency has just launched a major review of the program looking toward possible structural, regulatory and legislative changes. So, I'm sure you can appreciate our position that it is not the time to throw bombs at the Agency.

There is always a reasonable degree of friction between a governmental regulatory agency and the industry it regulates. This is certainly true for the SBIC program. Clearly, that friction level was at its peak during the prior Administration when attempts were made to close down or seriously cripple the program.

We were very encouraged by the new Administration's attitude, initiative and responsiveness toward small business in general, and the SBIC program in particular. Shortly after she was appointed, Ms. Engeleiter and the rest of SBA's new management team offered an open door and a sincere willingness to work with the industry in an effort to rebuild and improve the SBIC program.

However, based on a preliminary review of SBA's new proposed regulations it is clear that the friction level between the industry and the Agency is going to increase substantially over the next several months.

At the operating management level, we have consistantly promoted increased resources for the Investment Division of SBA. The Investment Division has played a critical role in developing and administering the SBIC program, but in recent years its staffing and capabilities have been significantly reduced.

We believe both the amount and quality of the Investment Division's resource capabilities should be increased. In reality, the SBIC industry will benefit if the SBA is able to carry out its mission at a high quality level of performance, and the industry will suffer if the agency performs at a lower level.

Otherwise, it is premature at this time to comment on the operating level mangement of the program. Some management changes have recently been made, interim management is now in place and we understand that the possibility of adding additional staff is now being considered.

Recommendations for Improvement in the Program

We do have a series of specific recommendations to improve the program.

1. SBA should adopt and implement the "Guidelines for the Valuation of Portfolio Securities" we have proposed for universal application to the SBIC industry.

2. SBA should withdraw it proposed regulation on government audit standards, and reissue it only when material changes are made - including the addition of specific guidelines which limit the scope of a CPA's compliance with laws and regulations audit to the "Big 6" and other changes mentioned earlier.

3. We previously recommended to SBA that the minimum capitalization for a newly licensed regular SBIC be raised to the level of at least $2.0 million, because very small SBICs are often unsuccessful as a result of undercapitalization. SBA announced last week that it was raising the minimum capital requirement for regular SBICs to $3.0 million, and for specialized SBICs to $2.0 million. NASBIC supports those changes.

This change should produce a significant side benefit for the program, as more substantially capitalized SBICs will be able to attract more experienced and better qualified managers.

4. We recommend that SBA raise the minimum qualification standards for managers of SBICs.

SBA's current qualification requirements reflect an absolute bare-bones minimum standard that should be raised. Better quality managers should enhance the performance and profitability potential of SBICs.

5. The SBA should inplement the major regulatory changes we have recommended to the Agency.

We have identified a series of current SBA regulations that are having a serious dysfuctional affect on the ability of SBICs to operate effectively in today's commercial markets. We have recommended specific and detailed changes in those regulations which could improve the performance of SBICs and enhance their capacity to finance small business.

6. The current statutory basis for SBIC access to 4th tier leverage should be changed.

Under existing law, 4th tier leverage is only available to SBICs that have an investment portfolio that is comprised primarily of "venture" or equity type investments. This provision was put in the statute as an incentive to SBICs to invest in more venture-type deals. However, it has not produced that result because it defies economic logic. If an SBIC is highly leveraged it will need substantial cash flow to meet its debt service requirements. An SBIC with a portfolio comprised primarily of venture-type investments, however, will normally produce insufficient cash flow to handle that kind of debt service requirement.

7. SBA should take the necessary actions to reaffirm that the Investment Division has clear regulatory authority and responsibility over the SBIC program, while the role of the Inspector General's office is that of regulatory compliance audit fact-finding.

8. SBA should set up a streamlined process through which the portfolio securities of SBICs placed in liquidation can be offered to operating SBICs. A comprehensive inventory of those assets would be a good starting point.

9. SBA should increase both the level and quality of the Investment Division staff and resources in order to assure effective management of the SBIC program.

Mr. Chairman, we appreciate the opportunity to testify on these subjects of vital importance to the industry, and we would be pleased to answer any questions you or members of the Committee may have.

NASBIC

June 4, 1990

PETER F. McNEISH

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Editor of Business Week
c/o Readers Report
Business Week
1221 Avenue of the Americas
New York, NY 10020

Dear Sir:

Our industry has been a strong supporter of your coverage of small business issues. Unfortunately, your article on Small Business Investment Companies ("The Iran-Contra Scandal of the Small Business World," Small Business, June 4) is irresponsible journalism that has unfairly damaged a sound financial program important to small business.

Your article paints the SBIC industry as a good program that has gone bad, has outlived its usefulness, is mired in defaults and may be closed down by Congress. That portrayal is totally unfounded, based on factual errors, half-truths, misleading innuendo and wrong conclusions.

The SBIC program continues to have a positive record of building small companies. Congress is quite aware of the outstanding results achieved by the SBIC industry, and has no intention of terminating the program.

The assertion in the article that the "market is sending signals that the program may have outlived its usefulness" is completely at odds with reality. In today's credit crunch climate, banks and other conventional sources of capital have become risk-averse to small business, making venture financing by SBICs for small growth companies more essential than ever.

The truth is that SBICs have provided over $9.0 billion in critically needed venture capital to over 60,000 small growth companies. Certainly, we're proud of our outstanding successes - home runs like Federal Express and Apple Computer. But even more important, we continue to provide capital to a broad array of less spectacular - but equally essential - small businesses that fuel the American economy. These are the singles, doubles and triples by successful, growing companies that produce jobs, innovations and new products and pay taxes.

NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES
1156 15th Street, NW • Suite 1101 • Washington, DC 20005 • Tel (202) 833-8230 • FAX (202) 775-9158

The implication in your article that SBICs are similar to "hemorrhaging thrifts" that were thinly capitalized and poorly managed is a gross distortion. Every SBIC has a private capital base equal to at least 25% of its assets, and in most cases far higher. Currently, the 401 SBICs in the program have private capital of $1.9 billion, which far exceeds the $1.2 billion of government-backed loans outstanding.

It is true that the rate of SBIC defaults has increased over the past five years. That fact should not be surprising for a high-risk investment business in the context of an economy that has seen many segments of the financial markets experiencing difficulties. However, even here the picture your article paints is distorted. According to official SBA statistics, 160 SBICs are currently in default with loans of $486 million (not the $563 million figure cited in your article). More important, that is a cumulative figure aggregated over an extended period of years - dating back to the 1960s. Over that same period 1,500 SBICs have been licensed and $3.0 billion has been loaned to them. Therefore, only 11% of all SBICs and 16% of all funds loaned to SBICs are currently in default - percentages we find quite defensible for a high-risk venture investment program.

Your article incorrectly suggests that a default means the SBIC has been a total failure and the government stands to lose all funds loaned to that company. In fact, many SBICs, prior to going into liquidation, have made a substantial number of successful investments, and many of those assets have substantial value. Moreover, the major losers when an SBIC defaults are the private investors who lose all their invested capital before Uncle Sam loses one dime. Because private dollars buffer the government from losses, and the SBA has been able to realize value from the assets of defaulted SBICs, the government's actual rate of recovery on SBIC defaults has been 68.7% and its net realized loss from the SBIC program has been less than 2%.

Your article incorrectly implies that the government will have to come up with hundreds of millions of dollars to pay for losses on SBIC defaults, similar to the S&L bailout. In fact, the program was designed to anticipate losses because of its high-risk nature. SBA has provided an annual reserve for losses for the past 32 years. The reserve fund is more than sufficient to cover all projected losses from the program, and additional taxpayer dollars to cover losses will not be required.

The article incorrectly asserts that large hidden losses in the program will soon emerge, claiming that 20% of the operating SBICs are "candidates for failure." In fact, SBA's rating of operating SBICs has determined that only 4% of currently operating SBICs are in an unsatisfactory status. The article also lifts a quote from a consultant's report out of its proper context to suggest that the default trend was moving from a "critical to melt down stage." In fact, that quote did not refer to default trends. Rather, it characterized SBA's understaffing and insufficient resources to manage assets in liquidation.

Your article incorrectly states that budget cuts forced the SBA to cut back its annual audits of SBICs to every other year. In fact, budget cuts had nothing to do with the change to biennual audits. Congress changed the statutory annual audit requirement at the agency's request because the Inspector General of SBA found that 70% of the annual SBIC audits contained no adverse findings and were an inefficient use of his resources.

Your article incorrectly claims that fear of government cuts in funding have discouraged the formation of new SBICs. In fact, Congress has consistently provided adequate funding for the program. The drop in SBIC licensing over the past five years is directly attributable to the Reagan Administration's proposal to close the SBA and terminate the SBIC program. These actions created enormous uncertainty and discouraged potential investors from forming SBICs. With the Bush Administration's support for the program, that trend has now been reversed, with 19 new SBIC licenses issues so far in 1990, an additional 35 license applications pending and a resurgence of interest in the program.

Your article incorrectly cites the Royal Business Funds case as evidence that the program has too few safeguards. In fact, the Royal case had nothing to do with program safeguards or regulations. That case dealt with SBA's management of the company's assets years after it was placed in liquidation.

Finally, your article gives the misleading impression that a recent rash of SBIC defaults have suddenly created a crisis atmosphere in Washington. In fact, we're looking at defaults that evolved over a 10-year period, with the Royal liquidation in 1981 and River Capital in 1989; there is no crisis; and neither Congress nor the Administration is overreacting.

Your article completely neglected the positive side of the SBIC story. SBICs have successfully financed small, high-risk growth companies for over 30 years. The impact of those investments on our economy have been enormous - creating jobs, producing new products and technologies, generating additional tax revenues, enhancing the U.S. competitive position and fostering the entrepreneurial spirit in America. That's the story that should be told.

Your magazine has a powerful influence on American business, and it is truly regretable that your irresponsible article may cause many investors not to invest in SBICs. You have unfairly damaged our industry in the eyes of the business community and Washington policymakers, and in the process you have hurt small business.

Peter F. McNeish, President
National Association of
Small Business Investment Companies
Washington, DC

GUIDELINES FOR THE VALUATION OF PORTFOLIO SECURITIES

Objective - These guidelines are intended to provide (1) a conservative basis for establishing the fair value of portfolio securities held by licensees, (2) a set of consistent valuation standards which can be relied upon by the licensee's investors and the government, and (3) a uniform audit process to verify the reasonableness of the licensee's valuations.

Responsibility - The licensee's Board of Directors or General Partner(s) has (have) the sole responsibility for valuing portfolio securities in good faith. It is incumbent upon the Board of Directors or General Partner(s) to satisfy themselves that all appropriate factors relevant to fair value have been considered and the method used to establish fair value is reasonable and prudent.

Methodology - No single method for determining value in good faith can be established, since fair value depends upon the circumstances of each individual financing and investments by licensees are generally venture-type investments in closely held, non-mature small firms whose stock is not publicly traded. Acceptable valuation methods may be based, for example, on the financial condition and/or earnings capacity of the small concern, a multiple of earnings, a discount from or a premium higher than the market price of a similar security that is freely traded, a yield to maturity for debt securities, or on a combination of those or other factors. All relevant factors should be considered in selecting the method of establishing the fair value of each portfolio security.

Procedure - The Board or General Partner(s) may appoint management or other individuals to assist in the valuation process, to provide supporting data and to make necessary calculations.

Documentation

(1) Each licensee shall develop and maintain a written statement, approved by the Board or General Partner(s), of its valuation policy and procedures.

(2) Each valuation decision should be set forth in the minutes of the Board/Partner(s) meeting.

(3) Each licensee shall prepare and retain in its files a valuation report for the valuation of each portfolio security which documents the factors, methodology, supporting data and calculations used to establish value.

(4) Licensees shall obtain current financial statements from each portfolio concern at least annually, except as noted below. Such financial statements may be unaudited, but shall include a statement of assets and liabilities and a profit and loss statement. Where production of financial statements would cause undue hardship to the small concern or financial statements are not essential to valuation of the portfolio security, the Licensee shall obtain a copy of the small concern's most recent Federal income tax return.

Frequency - Portfolio securities should be valued at least annually as of the close of the licensee's fiscal year, or more frequently where deemed necessary by the Board or General Partner(s).

Minimum Standards for Valuations - Each licensee should apply the following minimum standards to the valuation of its portfolio securities, and all valuation adjustments should be disclosed in the licensee's valuation report for the affected portfolio concern:

Securities of Private Companies

1. Investment cost is presumed to represent value except as indicated otherwise in these standards.

2. Valuation should be reduced if the portfolio company's performance and potential have significantly deteriorated.

3. Valuation should be adjusted to equate to a subsequent significant equity financing that includes a sophisticated, unrelated new investor. A subsequent significant equity financing that includes substantially the same group of investors as the prior financing should generally not be the basis for an adjustment in valuation.

4. Valuation may be adjusted if the company has been self financing for at least two years and has been cash flow positive for at least one year. The adjustment should be based on P/E ratios, cash flow multiples or other appropriate financial measures of similar companies. The valuation should be discounted by an appropriate percentage for illiquidity, unless liquidity is provided for through redemption or registration rights.

5. Warrants and options should be valued at the excess of the value of the underlying security over the exercise price.

6. Valuation of convertible debt should be adjusted to reflect the value of the underlying security net of the conversion price.

7. Valuation of collateralized securities should include consideration of the value of the underlying collateral, and appropriate adjustments should be made for changes in the value of that collateral.

8. The carrying value of interest bearing securities should not be adjusted for changes in interest rates.

9. Valuation of interest receivables on interest bearing securities should reflect the portfolio concern's financial condition, its payment history and its ability to generate sufficient cash flow to make interest payments. Past due interest should not be valued or converted to a security with carrying value if: (a) interest payments are in default more than six (6) months; (b) the ability of the company to make payments is considered doubtful; and (c) the interest bearing securities do not have a substantial underlying equity value as determined by the above criteria.

Securities of Public Companies

1. Publicly traded securities should be valued at the closing price or bid price except as indicated otherwise in these standards.

2. The valuation of public company securities that are restricted should be discounted appropriately until the securities may be freely traded.

3. When the number of shares of publicly traded securities held by the licensee is substantial in relation to the usual quarterly trading volume, the valuation should be discounted by an appropriate percentage for illiquidity.

Valuation Audit Process

General - The auditing procedures relating to the investment accounts of licensees require greater attention than those of a conventional commercial enterprise because of the relative significance of such assets to the licensee's financial condition.

Auditor's Responsibility - The independent auditor does not act as an appraiser for portfolio security valuations established in good faith by the Board or General Partner(s), is not expected to substitute his or her judgment for that of the licensee's Board or General Partner(s), and does not have the responsibility to determine or estimate the value of a licensee's portfolio securities.

The licensee's Board of Directors or General Partner(s) has (have) the sole responsibility for valuing portfolio securities in good faith.

The independent auditor, however, does have the responsibility to examine, exercise appropriate due diligence and report on the reasonableness and adequacy of the methods, procedures, internal controls and documentation used by the licensee's Board or General Partner(s) in determining the fair value of portfolio securities.

Audit Procedure

1. AICPA Audit Guide - The audit procedures set forth in the AICPA's Guide for Audits of Investment Companies should be followed in auditing licensee valuations, supplemented by the following additional procedures.

2. Conformity With Policy and Regulations - The auditor should determine whether the valuation methods used conformed with the licensee's stated policy. The auditor should also determine whether the licensee's valuations met the minimum standards for valuation required by the regulations of the Small Business Administration.

3. Valuation Methods - The auditor should determine that relevant factors were considered in selecting the methods for valuation and that the methods used by the licensee to establish fair value were reasonable and prudent in the circumstances relating to the investment portfolio.

4. Internal Procedures - The auditor should determine that the internal procedures and controls used by the licensee to establish valuations were reasonable.

5. Information Basis for Valuations - The auditor should determine that the market factors, financial data and other information used to establish valuations was current, accurate and applicable to individual portfolio companies. Where appropriate, the auditor should test the information used as a basis for valuations. The extent of those tests should be based on the auditor's judgment and his or her study and evaluation of the data and procedures used to establish valuations.

6. Documentation - The auditor should determine that the valuations were adequetly documented and recorded.

Opinions on Valuation in the Independent Auditor's Report

Because most licensee portfolio securities do not have readily ascertainable market values, good faith valuations present a unique reporting situation for the independent auditor.

Consequently, the auditor has the option to issue an opinion in one of the following forms:

1. **Unqualified Opinion** - If the auditor concludes, based on examination of available evidence, that the process used to establish valuations is reasonable, the documentation is appropriate, and the range of possible values is not significant, he should issue an unqualified opinion on the valuations.

   The auditor may also choose to emphasize the inherent uncertainty about the valuations by inserting an informative paragraph in the audit report explaining the lack of definitive market values for the licensee's portfolio securities. An explanatory insert of this kind should not be considered a modification of, or qualification to, the auditor's unqualified opinion.

2. **Modified Opinion** - If the auditor concludes that the process used to establish valuations is reasonable and the documentation is appropriate, but the range of possible values of the licensee's portfolio securities is significant, the auditor's unqualified opinion should be modified to note the lack of ready market values and to indicate that the significant uncertainty about values could be material to a fair presentation of the value of the licensee's portfolio securities.

3. **Qualified Opinions**

   a. If the auditor's examination discloses that the valuation procedures do not conform with the licensee's policies or SBA's minimum standards for valuations, the auditor should issue a qualified opinion indicating a failure to comply with those policies or standards.

   b. If the auditor's examination discloses that the valuations are unreasonable or that the underlying documentation does not support the valuations, the auditor should issue a qualified opinion indicating a failure to conform with generally accepted accounting principles.

Notice to SBA - If a qualified opinion on valuations is issued, the auditor shall simutaneously notify SBA of the opinion, including with the notice a statement explaining the reasons for the qualified opinion and appropriate supporting documentation.

NASBIC

September 24, 1990

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PETER F. McNEISH

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Mr. Thomas C. Bresnan
Staff Accountant
Office of Investment
U.S. Small Business Administration
1441 L Street N.W., Room 808
Washington, DC 20416

Dear Mr. Bresnan:

This letter represents the views of the National Association of Small Business Investment Companies (NASBIC) on SBA's proposed rule which would require independent public accountants to audit the financial statements of small business investment companies pursuant to government auditing standards (GAS) for financial audits, as published in *Government Auditing Standards* issued by the Comptroller General of the United States (commonly referred to as the "Yellow Book."). This proposed rule was published in the *Federal Register* on August 23, 1990 (Vol. 55, No. 164).

As you know, NASBIC is the national trade association for the SBIC industry, and this proposed rule will have a material effect on the operations of our member company SBICs.

Our comments fall into the following categories:

- Objections to implementation of the proposed rule,
- Specific reasons why SBA should withdraw, revise and re-propose the subject rule, and
- Recommended technical revisions to the rule.

NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES
1156 15th Street, NW • Suite 1101 • Washington, DC 20005 • Tel: (202) 833-8230 • FAX: (202) 775-9158

OBJECTIONS TO THE PROPOSED RULE

NASBIC objects to the proposed rule for the following reasons, and recommends it be withdrawn.

1. Imposition of the proposed rule is unnecessary.

SBA itself points out in the supplementary information section of the proposed rule that under generally accepted auditing standards SBIC auditors are already required "to obtain an understanding of the SBIC's internal control structure and assess the control risk involved, to test compliance with laws and regulations if noncompliance could significantly impact the SBIC being audited, and to report on financial statements."

Clearly, if an independent auditor operating under generally accepted accounting standards finds internal control risks or non-compliance with laws or regulations that could have a direct and material effect on the SBIC's financial condition, the auditor is required to include that in his/her opinion on the SBIC's financial statements. Generally accepted auditing standards cover the subjects of the proposed rule, and additional reports are not required.

2. The Proposed Rule Does Not Address The Issues.

The primary audit-related issue raised by recent Senate oversight hearings on the SBIC program relates to valuation of portfolio companies, an issue that is not addressed in this proposed regulation. The hearings did not raise issues related to internal controls or compliance with laws and regulations, and SBA has not otherwise presented any foundation or logical justification for the imposition of these new, unnecessary requirements.

3. The New Requirements Will Duplicate the Inspector General's Audit Function.

SBA states in the supplementary information section of the proposed rule that:

"The imposition of these additional standards on independent public accountants is not intended to supplant the Agency examinations of SBICs which are required by statute to be performed on at least a biennial basis." (emphasis added)

To the contrary, the implementation of the new requirements on independent auditors to test and report on SBIC "compliance with laws and regulations" will, in fact, be a direct duplication of the Inspector General's regulatory compliance examination. The new GAS requirement establishes a duplicate regulatory compliance process. The result will be two potentially conflicting regulatory compliance audits, both of which are paid for by the SBIC. This form of regulatory overkill is not necessary, nor has it been justified by SBA.

4. The Proposed Additional Audit Requirements Will Be Very Expensive for SBICs.

SBA certifies in the supplementary information section that the proposed rule would be a nonmajor rule because "2. It is not likely to result in a major increase in costs for . . . the investment company industry, . . ."

We believe the Agency is dead wrong on this point. Our discussions with independent CPA firm executives familiar with both SBIC financial audits and government audit standards indicate that the cost of SBICs audits will increase from 50-100% if this proposed rule is implemented in the form proposed.

At a time when other SBA actions have increased SBIC operating costs and reduced the capacity of SBICs to earn income on financings, increased audit costs of this magnitude will have a direct and material negative effect on the ability of individual SBICs to operate profitably.

We believe SBA should provide appropriate data to support its assertion and certification that the proposed regulation will not cause a major increase in costs for the SBIC industry.

Further, we strongly recommend that if SBA does impose these new audit requirements, that the cost of the duplicative Inspector General compliance audit be born by the Agency. Both compliance audits are government functions, and SBICs should not be forced to bear the duplicate costs. Fairness argues that the IG compliance audit function which is carried out by government employees with appropriated funds should not be charged to SBICs.

SBA SHOULD WITHDRAW, REVISE AND RE-PROPOSE THE RULE.

If SBA insists on proceeding with the imposition of government audit standards on the financial statements of SBICs, **a major and material defect in the proposed rule should be corrected** prior to its being published and implemented in final form.

SBA states in the supplementary information section of the proposed rule that:

> "An audit guide specifically addressing the compliance aspect of an SBIC audit is currently under development by the Agency. Until such time as a new audit guide is adopted, the auditor shall design appropriate compliance tests in accordance with *Government Auditing Standards* and shall obtain an understanding of the SBIC's internal control structure and make an evaluation thereof."

The critical problem with this approach is that the *Government Auditing Standards* do not provide the auditor with any concrete or specific standards on regulatory compliance. To the contrary, the GAS "Yellow Book" directs the auditor to "identify the pertinent laws and regulations and determine which of those laws and regulations could, if not observed, have a direct and material effect on the financial statements . . ."

The result is a gaping hole in the regulation which leaves the auditor totally in the dark and with no guidance whatsoever as to what laws and regulations could materially effect an SBIC's financial position. To protect itself from liability in this situation, any sensible auditor will be forced to test the SBIC's compliance with every conceivable law and regulation on the books, including, but not limited to the complex set of regulations promulgated by SBA for SBICs. The cost to SBICs for this exercise would be untenable.

Moreover, the practical effect would be several hundred different auditors applying several hundred different audit testing standards to different SBICs, all of which would be subject to second-guessing by the Inspector General who's office has the compliance audit experience and the Investment Division which has the regulatory, interpretive and compliance expertise. The practical result would be audit chaos at just the time when we are entering the fiscal

year-end and audit season for the majority of SBICs. This result would totally undermine the intended purpose of the proposed regulation.

In order for the final regulation to be functional and fair to all parties concerned, it must contain specific and detailed standards against which the auditor can test for compliance with laws and regulations and internal controls.

We strongly encourage SBA to withdraw the proposed rule, to complete the proposed "audit guide" and incorporated the guide into a revised and re-proposed rule. In order to avoid substantial disruption of the pending audit cycle, the revised rule should become effective after March 31, 1991.

The revised rule and the audit guide incorporated therein should, of course, be subject to a reasonable period for public comment.

RECOMMENDED TECHNICAL REVISIONS.

1. We recommend that the "Summary" and "Supplementary Information" sections and the actual revisions to Part 107 contained in the proposed rule be restated to make it absolutely clear that only the **financial** auditing standards of the *Government Auditing Standards* are being applied to SBICs by the proposed rule. Stated another way, the rule should make clear that "performance" and other types of standards found in the GAS "Yellow Book" that are designed for government agencies, etc. are not being applied to SBICs.

2. In the example of the standard audit report, the terminology used in the last sentence in the fourth full paragraph appears to inherently conflict with the fifth and concluding paragraph in that example. Paragraph four (refering to valuations) says " . . the differences could be material." The concluding paragraph, on the other hand, says "In our opinion, the financial statements referred to above present fairly, in all material respects, the . . ."

If the valuation differences could be material, can the financial statements be a fair presentation "in all material respects?"

3. In the example of the report on internal control procedure, the second full paragraph is confusing and very difficult to understand. We would suggest the paragraph be reworded to clarify its intent.

4. In the example of the report on internal control procedure, the fifth full paragraph includes a paranthetical reference which indicates that the auditor should "identify internal control structure categories." We would suggest that SBA provide detailed guidance to auditors on what types of internal control structure categories it wants to be identified.

5. In the example of the report on internal control procedure, the eighth full paragraph makes reference to "SBA's related requirements," without citing or defining the specific requirements intended. We would urge SBA to revise this paragraph to give guidance to the auditor by including citations to specific control requirements contained in SBA regulations. (This guidance could be included in the proposed "audit guide.")

6. We note that the citations in the "Authority" section of the proposed rule differ from the citations shown in the most recently published version of 13 CFR 107.

NASBIC appreciates the opportunity to comment on this proposed rule. Should you have any questions on our comments, or require clarification on any points we have made, please feel free to contact us.

Sincerely,

Peter F. McNeish
President

Addendum
to the
Statement of Walter H. Wilkinson, Jr.

Before the Committee on Small Business
U.S. House of Representatives

October 2, 1990

Mr. Chairman and Members of the Committee:

Your letter inviting us to testify today arrived after we had completed our prepared written statement. That letter contained several questions which our statement did not address directly. This Addendum to our statement provides our answers to those questions.

Q - What is the program designed to do? Should it emphasize the providing of equity or debt? If equity, how will SBICs make their debt service payments to SBA when their (equity) investments will not bring them cash flow for a number of years?

A - As you know, the statutory intent of the SBIC Program is to provide "equity capital and long-term loan funds" to small business concerns. (emphasis added)

> (See the Statement of Policy in Section 102 of the Small Business Investment Act of 1958, and related provisions of the Act dealing with SBIC financings in the form of either equity or debt.)

The short and oversimplified answer to your question is that the program is designed to do both.

SBICs provide long-term "patient capital" to small business which is not available from traditional money sources. In practice this patient capital is provided to small firms in many forms. These financings cover a broad range financial structures. At one end of the spectrum are investments in conventional types of pure equity, such as common or preferred stock. On the other end of the spectrum are straight, long-term loans. Between those two extremes there are a wide variety of financial structures which combine features of both debt and equity.

Each SBIC financing is a negotiated transaction between the small business concern and the SBIC. The form and structure of any specific deal will generally be determined by a combination of (a) the type of financing best suited for the small business concern, and (b) the type of financing the SBIC can make within the parameters of its investment policies.

As you might expect, the investment policies of SBICs vary widely, depending on the investment objectives of their owners, their asset/liability structure, their financial condition, and the market in which they invest.

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Servicing SBA debt comes down to a question of the SBIC's management of its assets and liabilities. SBICs that use leverage must make investments that produce sufficient cash flow to service that debt. This means that they must either produce sufficient income from their debt-structured financings, or their exits from equity investments must be timed to produced sufficient liquidity to service the debt, or some combination of both.

Q - Should SBA's policy of subordinating its creditor position to all other creditors of the SBIC be changed?

A - NASBIC supports a reasonable limitation on the subordination of SBA's creditor position.

Q - What program demand (for leverage) or annual program level needs are expected? What is the cause of leverage utilization dropping to such low levels? Has the Agency changed its criteria for approval of debentures?

A - Refundings of outstanding leverage for regular SBICs may run in the range of $50 to $75 million per year over the next five years. In addition, a survey of regular SBICs that we completed earlier this year projected a demand level for new leverage funds in the range of $100 to $150 million per year over the next five years. The combined level of projected demand for regular SBICs (exclusive of SSBICs), then, would be in the range of $150 to $225 million per year. These projections assume a relatively stable market for investments, no major attrition in the industry and reasonable SBA credit standards.

Leverage use by regular SBICs has dropped substantially over the last 4 years, as indicated by the following numbers:

Fiscal Year	Leverage Used
1987	$152 million
1988	$118 million
1989	$ 50 million
1990	$ 59 million

We believe the causes involve, in part, a variety of market factors which impact each SBIC in different ways. These include the liquidity position of the SBIC, the quality of investment opportunities for the SBIC, the economic conditions of its market, the condition of the SBIC's current portfolio, and a series of external economic factors outside the SBIC's control.

In addition, the prior Administration's efforts to close down SBA effectively shut off the pipeline of new SBIC formations. Those actions materially contributed to an attrition in the industry's size and demand base for leverage. The delayed impact of those actions was reflected in the drop-off in leverage usage in 1988-1990.

Finally, we are convinced SBA has materially tightened its criteria for leverage. This is difficult to prove, since we do not have access to SBA's decision actions on SBICs, and the Agency has never advised the industry in specific terms what credit criteria is applied to leverage applications. However, the high "scrub-out" rates on leverage requests, coupled with anecdotal evidence from discussions with rejected SBICs, makes it clear to us that SBA has significantly raised its threshold, and is now extending leverage to only "gold plated" SBICs that are in outstanding financial condition. Moreover, it now appears that the pressure from recent Congressional hearings and negative press coverage has caused the screws to be tightened further. Scrub-out rates had commonly been in the 30-40% range until the two latest fundings in June and September, when they jumped to 65% and 80% respectively.

Testimony by

Walter L. Threadgill

Legislative Chairman, National Association of Investment Companies

President, Minority Broadcast Investment Corporation

Washington, D.C.

before the

House Small Business Committee

October 2, 1990

The National Association of Investment Companies appreciates this opportunity to appear before the House Small Business Committee to discuss and address a variety of issues concerning the financial health and viability of the Specialized Small Business Investment Company industry.

I am Walter Threadgill, Legislative Chairman of the National Association of Investment Companies and President of Minority Broadcast Investment Corporation. I am pleased to have the opportunity to testify today and provide the minority venture capital industry perspective to your inquiry regarding the health of the industry. As a Specialized SBIC executive for the past ten years and the owner of my investment company for the past five years, I have been a part of the evolution and growth of the industry.

The Specialized SBICs are particularly concerned with recent developments and proposals in the SBIC industry because they come at a time when we had hoped to launch into a new era of high growth and development. We have few companies being transferred to liquidation, and although the industry average is 24% the percentage of specialized SBIC debentures which have been accelerated over the past ten years due to liquidations is 12%.

On the contrary, although we're certainly not claiming to be perfect, our profitability and stability is better than it has ever been. Less than a year ago you led the fight to pass a bill which finally ended the leverage funding shortage this industry had experienced for so many years. We believed we were finally going to achieve the growth and development we knew the industry was capable of.

Unfortunately, the current situation has once again cast a shadow on the industry, and at some points even appears to threaten the continued existence of the minority venture capital program.

We are particularly concerned with the attitude expressed in the Small Business Administration's most recent set of regulatory proposals. We will be meeting with the Agency to comment on the proposals in detail, but can not help but be dismayed at such SBA statements as that made to justify the limitation of pension fund investments in SBICs because . . . "SBA does not think that, for the purposes of the SBIC program, pension funds are suitable investors, or SBICs suitable investments for pension funds, because pension funds need reliable and steady investment income. This need is incompatible with the venture capital mission of the SBIC program."

We were under the impression that Congress addressed the question of suitable investments for pension funds when it passed ERISA. To have our agency of advocacy attempting to label us to outside investors as an even higher risk than other eligible venture capital vehicles which are able to attract pension funds reflects an attitude that has us extremely concerned.

We are also concerned about proposals such as the recommendation by independent contractors hired by the SBA which would require our companies to declare and pay dividends to the SBA before they would be eligible to receive leverage. this proposal was alluded to in Administrator Engeliter's testimony before the Senate Small Business Committee.

Chairman LaFalce, the issue of dividend payments on our companies' preferred stock is one which your committee worked hard to resolve less than a year ago. As you are aware, the management of many of our companies believe it is important to retain earnings to continue to strengthen their companies. Their private sector shareholders support this strategy, and have agreed to forego the declaration of dividends during this crucial stage. The public sector partners in the SBA, however, would prefer to force the company to declare and pay dividends. this would weaken the balance sheets of our companies at a time when we can least afford it.

The proposal which you spearheaded, and which was passed as part of the fiscal year 1990 authorization bill, would solve this statement. The new law authorizes the SBA to offer our investment companies the opportunity to repurchase their preferred stock at a discount. In this way, the SBA could recoup funds from the preferred stock at the same time our companies could potentially improve their balance sheets as a result of the discount.

NAIC has been working with the Investment Division toward the implementation of the discount repurchase program prior to the end of this year. We urge you to encourage the SBA to continue its progress on this program to strengthen our industry rather than forcing our companies to take actions, such as the declaration and payment of dividends, which would weaken our industry.

As the Committee is aware, the Specialized Small Business Investment Company program was created to provide patient capital to minority entrepreneurs

across the Country. It is with great pride that we have built an impressive track record financing companies across the Country who have created value, provided jobs and contribute to the economy. The prefinancing information on portfolio companies which I have attached to my statement demonstrates the increasing sophistication and success of our portfolio companies. The average revenues of our companies has grown from $897,108 in 1978 to well over $1.1 million by 1989. The average assets have grown from $387,337 to almost $700,000 in the same time period.

1990 marks the twentieth anniversary of the Specialized SBIC program. The industry was created in 1970 as a "Black Capitalism" initiative. During our first decade, we struggled to define the balance between the social and the economic roots of the industry. The seventies were witness to the failures of many of our early companies which were unable to find that balance.

By 1980, much of the industry had moved up the learning curve and although we were not yet a profitable industry, we had every reason to be optimistic. The 80's promised to be our turning point. Although unprecedented interest rates and a recession delayed our progress -- not to mention a former president who tried for several years to eliminate the SBA and our program -- we did in fact become a profitable industry in 1986.

At our twenty year mark in 1990, the industry is healthier than it has ever been. Since 1970, we have invested over $1 billion in businesses owned by socially or economically disadvantaged entrepreneurs. We have travelled up the

learning curve and our members are now the recognized experts in minority venture capital. Just as important as our direct investments is the additional capital sources we bring to our deals. For every dollar we invest, we raise an additional two dollars in bank or institutional financing to syndicate and structure deals. And, thanks to a large extent to the work of this Committee, after several years of funding shortages, we finally have access to the capital we need to continue to grow.

In 1990, we are still the primary source of capital that dedicates 100% of its resources to minority financing. The philosophical justification for the creation of the Specialized SBIC program (MESBICs) was to stimulate the creation of a vehicle managed and operated by the private sector to invest in a sector of the economy that was not being served by the traditional financial community. The rationale was sound and the results twenty years later provide documented evidence that the program works. In fact, our industry represents an increasingly vital source of capital to the minority business community. At the same time we have increased our investments in minority businesses, other capital sources have dried up. Blacks in particular have experienced this as their portion of SBA guaranteed loans has gone from $97 million in 1970 to $180 million in 1980 all the way down to $71 million in 1988. We are one of the few remaining sources dedicated to minority business financing.

Concern has been expressed over the high risk nature of the program and it has been suggested that additional steps must be taken to minimize the risk to

the government. However, the legislative mandate that this industry operates under demands that we assume a high level of risk, that we participate in deals where capital cannot be raised through commercial sources, and that we increase the pool of minority firms across this Country. In fact, the Small Business Investment Act as amended in 1972 provides for a special class of investment company whose "*investments will be made in small business concerns which will contribute to a well balanced national economy by facilitating ownership in such concerns by persons whose participation in the free enterprise system is hampered because of social or economic disadvantage.*" We are to create an economic environment where minority firms can grow, raise capital from diverse financial sources and provide employment.

In 1979, the Small Business Investment Act was amended again as it relates to the minority investment companies because it was felt that many of the investment companies were too *conservative* in their investment strategies and that minority firms were not able to raise capital through the very investment companies that were created to serve their needs. As a result a special class of stock was created and to obtain eligibility for this layer of government leverage the minority investment companies were required to invest in equity securities defined as "*stock of any class or unsecured debt instruments which are subordinated by their terms to all other borrowings of the issuer.*" This means no collateral-- not even personal guarantees. This is the law. In fact, the SBA recently proposed regulations which further clarify that they do not want Licensees to hold any

sembiance of collateral in these deals - they must be structured as what most would consider to be high risk investments.

Congress in its wisdom was willing to provide incentives to the private sector and challenged private industry to make an investment in a sector of the economy that is not being served by the traditional financial community. The private sector invested the human talent and close to $250 million to operate successful investment companies. The total federal dollars invested in the specialized investment company industry since the inception of the program totals $445 million. With these funds we have invested over $1 billion dollars in minority deals. And for every dollar of capital we invest two additional dollars are raised. The tax revenues collected in one year by the local, state and federal government total over $141,423,596 million, as demonstrated in the chart attached to my testimony. The amount of interest the industry has paid on its outstanding debentures to the Small Business Administration is estimated at approximately $75 million to date. Most importantly, the minority venture capital industry in the aggregate is a profitable industry since 1986.

Based on data published by First Chicago Venture Capital Group, on a comparative basis the internal rate of return for private venture capital firms started after 1987 has been no greater than the yield for the minority venture capital industry.

Perhaps because of the unique charter of the Specialized SBIC industry, our recent experience regarding companies being transferred into liquidation has been

different from that of the balance of the industry. Last year we lost only three companies. During the last ten years we have averaged only six companies transferred to liquidation each year. This represents a turnover rate of approximately 4.5%. This information is provided in a chart attached to my statement.

In testimony before this Committee on March 17, 1988, NAIC President JoAnn Price indicated that a destabilizing environment was being created by the Reagan Administration over the proposals to eliminate the industry. We stressed that in a business that depended on stability these events would have a negative impact on the growth of the industry. We specifically pointed out that in 1980 when our funding was stable we had a private capital growth rate of 27%, but by 1987 our growth rate was less than 1%. We went on to say that for every company that entered the industry in 1987 and 1988, three left. When the Administration signalled a change in their position on the future of the agency private capital stabilized and continued to grow, and the number of companies exiting the industry began to shrink.

Our industry is now focusing on the potential gains we can realize as a result of the recent increase in our funding availability, increased interest from banks as a result of tighter compliance standards for the Community Reinvestment Act, and other factors which have produced a marked increase in the number of license applications.

Although there have been many proven minority business success stories the financial community has not substantially changed its financing criteria with respect to financing minority firms. The sad truth is that the larger venture capital community is not financing minority deals. The banking community is increasingly being subjected to more stringent credit tests by regulatory agencies and are unwilling to take what they consider increased risks in financing small companies even with the SBA loan guarantee program. The need for a viable source of minority capital for minority entrepreneurs is more critical today then it was twenty years ago. NAIC represents all firms that provide investment capital to minority firms. There are only six states that have developed capital programs directed at minority firms. They are Maryland, Massachusetts, Michigan, Florida, Ohio, and Pennsylvania. There are seven additional private venture capital type funds that do focused minority investing. That is the total universe of capital that is available to the minority business community today other than the MESBIC industry.

In preparation for this hearing, the leadership of the National Association of Small Business Investment Companies (NASBIC) as well as our officers discussed in detail the issues that have been the subject of the series of hearings held by the Senate Small Business Committee over the past several months. We discussed issues related to valuation, to audits, to regulatory compliance, to licensing, as well as SBA's program management. Our Legislative Committee as well as a task force of the Board of Directors developed recommendations designed to improve the

overall management of the program and at the same time ensure to the extent possible that the government role as a creditor is adequately protected. We are pleased to present a document of recommendations agreed to by both associations to the Committee. This document has been sent to Administrator Engelelter for her review and consideration.

Through most of the Congressional hearings, we have heard repeated testimony regarding the government exposure and the concern over potential losses of government funds. We are confident that this industry-developed document, which is already followed by many investment companies, will ensure our company executives are utilizing a prudent approach in valuing their investment portfolios. We also would like to take this opportunity to comment on additional areas.

Views of Present Licensing and Auditing System

Our industry's years of experience have taught us many things, chief among which is the fact that the most important determinant of an investment company's success is the talent of the investment executive. We believe the licensing process should be modified to place more emphasis on this factor.

Currently, those interested in operating Specialized SBICs must compile a comprehensive application that includes the statement of need, the investment philosophy, the management plan and the financial projections. In 1984, the qualifications for managers were strengthened to include very specific business

investment skills. This was an improvement, and an acknowledgement that talent is the single most important element in operating a successful small business investment company. We would propose additional guidelines:

1. The management criteria should be more specifically described. The qualifications and responsibilities should be outlined in a job description.
2. Investors and stockholders should be required to receive an orientation about the program and understand the legislative history and mandate.
3. Management of the small business investment company should be the core consideration during the review and evaluation process. The application should be revised to incorporate the management of the SBIC. Those interested in submitting applications should be told that this is one of the key considerations during the review process.

We believe these changes would help to ensure the quality of new investment executives coming into the industry and strengthen the program in the long run.

Currently all SBICs undergo an audit performed by the Inspector General. It is looked upon as primarily a compliance audit that looks very specifically at the big seven violations. Additionally, the company's CPA performs an annual

financial audit. Beyond this information, the Investment Division asks investment companies to clarify, defend or correct certain practices as reported in the IG examination.

Unfortunately, the audits vary from one region to the next. While auditors in one region may be thorough in their examination of company financials and practices, requiring investment companies to provide detailed information on their valuations of portfolio companies, auditors in other regions may be comparatively lax in the same areas. We believe it is important for audits to be standardized from one region to the next. If auditors do not currently have standard operating procedures and professional standards, they should be adopted to help in this regard.

Additionally, more effective monitoring of investment companies can be accomplished by instituting the following measures:

1. Incorporate in the annual SBA audit more specific information on valuation procedures. A written valuation policy and procedure should be required and reviewed as part of the audit process.
2. The policy and procedure providing guidance on valuation procedures should be rewritten and more specific guidelines should be developed.
3. Investment Division officials should visit investment companies annually to review management and investment strategies. These visits should be made after the annual financial audit and the 468 are

submitted to the SBA. Written reports should be a part of the official file.

4. The regulations, the standard operating procedures and the policy and procedural releases should be part of the official documents provided to companies when licensed by the SBA.

How Auditing Procedures Might be Improved to Provide More Reliable and Complete Information

NAIC shares this Committee's goal of maintaining the strength and integrity of the SBIC industry. As this Committee works to identify the source and extent of problems within the industry, as I indicated earlier, our leadership has worked with the NASBIC leadership to develop measures which would minimize their potential recurrence.

As a result of this process we have developed a set of minimum standards for portfolio company valuations. These standards would require companies to be more conservative in their valuations, writing investments up or down only when market conditions dictate those changes.

We also have specified guidelines regarding an investment company's documentation of its valuation policy and procedures. These policies, procedures and documents would be subject to review by the company's independent auditor, who would issue an opinion on the reasonableness of the policies and procedures and the appropriateness and adequacy of the documentation.

We believe that these proposals will help to significantly improve the monitoring and valuation policies of companies, leading to their early detection of potential problems with portfolio companies. With early detection, our investment company executives will be able to work with their entrepreneurs to minimize potential losses to both the portfolio company and the investor.

We strongly object, however to the SBA's recent proposal to adopt government auditing standards for the industry's annual IPA audits. The proposed rule would result in a significant increase in the amount each Licensee must pay for its audit, simply to duplicate the activities which are supposed to be performed by the Inspector General's Office.

The NAIC/NASBIC proposal properly places the focus for the remedy to the industry's current situation on improving each company's operating procedures, rather than simply requiring them to pay for yet another audit. The proposal's combination of stricter valuation guidelines and a more structured audit of the valuation process would improve the industry's performance.

Recommendations on How to Improve the Program

In addition to our recommendations regarding licensing and auditing procedures, NAIC is working to improve all the operational policies and procedures of our industry.

Our Education Committee has just completed an Investment Operations Manual which provides companies with detailed procedures and documents in a

full spectrum of areas. We collected operational documents, checklists, and other forms used by investment executives from across the country to help identify those which have proven most useful and effective. These will be shared with the entire membership so that all our companies will have the benefit of the best information available.

This manual will be distributed to our industry in two weeks, during our annual convention.

Conclusion

Mr. Chairman and members of the Committee, it has been our pleasure to appear before you this morning. We feel it is vital that this industry continue. You have been an ardent supporter of our industry and our program. We sincerely hope that when these oversight hearings are concluded, the industry will be stronger for having been through this process. The next twenty years are crucial to the continued development of the minority venture capital industry. We have proven that we can successfully invest in specialized markets and make a return on investment. We have assisted in creating wealth and witnessed the positive impact many of these companies have had on individual communities. We have developed the venture capital talent, the national network, the deal flow and the institutional and entrepreneurial relationships. The future need is the ability to convince institutional investors and pension funds that investing in minority venture capital is an essential part of the minority economic development strategy.

PREFINANCING INFORMATION ON MESBIC-FINANCED BUSINESSES

REVENUE

YEAR	AVERAGE	MEDIAN	TOTAL
1989	$1,100,888	$366,883	$403,000,000
1988	$1,114,058	$383,474	$411,000,000
1987	$861,136	$341,049	$371,000,000
1986	$959,809	$330,223	$366,000,000
1985	$884,634	$327,247	$351,000,000
1984	$813,550	$220,652	$290,000,000
1983	$937,901	$300,675	$234,000,000
1982	$650,800	$195,689	$163,000,000
1981	$797,693	$210,795	$186,000,000
1980	$818,357	$254,032	$143,000,000
1979	$897,651	$265,000	$134,000,000
1978	$897,108	$305,556	$120,000,000

ASSETS

YEAR	AVERAGE	MEDIAN	TOTAL
1989	$694,629	$216,860	$356,000,000
1988	$581,524	$220,560	$238,400,000
1987	$562,004	$234,444	$255,000,000
1986	$641,440	$207,462	$260,000,000
1985	$572,960	$211,270	$242,000,000
1984	$530,449	$201,190	$215,000,000
1983	$595,053	$201,923	$165,000,000
1982	$499,904	$186,688	$131,000,000
1981	$423,689	$190,929	$113,000,000
1980	$609,936	$182,500	$119,000,000
1979	$517,230	$170,833	$77,000,000
1978	$387,337	$144,022	$59,000,000

1989 SPECIALIZED SBIC INVESTMENT STATISTICS

SBA Leverage	SSBIC Investments	Est. Total Financing	
$28 million	$148 million	$444 million	
		$148 M SSBICs	$296 M other private $

Total Number of Companies Financed	1,254
Estimated Revenues of SSBIC Portfolio Companies	$1,380,513,500
Estimated Total Employees	16,302
Estimated Portfolio Company Employees Payroll:	
Federal Taxes	$48,906,000
State and Local Taxes	$16,954,080
	$65,860,080
Estimated Portfolio Company Taxes Paid:	
Federal	$12,424,621
State/Local	$6,212,311
	$18,636,932
Estimated Payroll Taxes Collected	
FICA: Employees	$24,485,604
Company	$24,485,604
Total	$48,971,208
Unemployment Taxes:	
Federal	$912,912
State	$7,042,464
Total	$7,955,376
Total Governmental Collections	$141,423,596

Specialized SBICs Transferred Into
Office of Portfolio Management
1972 - 1990

Year	Amount Due SBA From Cos. Transferred	Number of Cos. Transferred	Number of Cos. In Industry	Turnover Rate
1972	$600,000	1		
1974	$300,000	1		
1976	$600,000	2		
1977	$1,000,000	1		
1978	$4,000,000	6		
1979	$9,861,957	8	110	7.27%
1980	$4,636,700	8	121	6.61%
1981	$5,571,950	8	130	6.15%
1982	$8,230,000	5	127	3.94%
1983	$2,850,000	3	144	2.08%
1984	$16,020,000	6	146	4.11%
1985	$5,220,000	3	148	2.03%
1986	$17,232,986	11	137	8.03%
1987	$16,249,500	10	135	7.41%
1988	$8,698,615	5	127	3.94%
1989	$6,330,000	3	132	2.27%
1990	$4,660,000	2	134	1.49%
	$112,061,708	83		

GUIDELINES FOR THE VALUATION OF PORTFOLIO SECURITIES

Objective - These guidelines are intended to provide (1) a conservative basis for establishing the fair value of portfolio securities held by licensees, (2) a set of consistent valuation standards which can be relied upon by the licensee's investors and the government, and (3) a uniform audit process to verify the reasonableness of the licensee's valuations.

Responsibility - The licensee's Board of Directors or General Partner(s) has (have) the sole responsibility for valuing portfolio securities in good faith. It is incumbent upon the Board of Directors or General Partner(s) to satisfy themselves that all appropriate factors relevant to fair value have been considered and the method used to establish fair value is reasonable and prudent.

Methodology - No single method for determining value in good faith can be established, since fair value depends upon the circumstances of each individual financing and investments by licensees are generally venture-type investments in closely held, non-mature small firms whose stock is not publicly traded. Acceptable valuation methods may be based, for example, on the financial condition and/or earnings capacity of the small concern, a multiple of earnings, a discount from or a premium higher than the market price of a similar security that is freely traded, a yield to maturity for debt securities, or on a combination of those or other factors. All relevant factors should be considered in selecting the method of establishing the fair value of each portfolio security.

Procedure - The Board or General Partner(s) may appoint management or other individuals to assist in the valuation process, to provide supporting data and to make necessary calculations.

Documentation

(1) Each licensee shall develop and maintain a written statement, approved by the Board or General Partner(s), of its valuation policy and procedures.

(2) Each valuation decision should be set forth in the minutes of the Board/Partner(s) meeting.

(3) Each licensee shall prepare and retain in its files a valuation report for the valuation of each portfolio security which documents the factors, methodology, supporting data and calculations used to establish value.

(4) Licensees shall obtain current financial statements from each portfolio concern at least annually, except as noted below. Such financial statements may be unaudited, but shall include a statement of assets and liabilities and a profit and loss statement. Where production of financial statements would cause undue hardship to the small concern or financial statements are not essential to valuation of the portfolio security, the Licensee shall obtain a copy of the small concern's most recent Federal income tax return.

Frequency - Portfolio securities should be valued at least annually as of the close of the licensee's fiscal year, or more frequently where deemed necessary by the Board or General Partner(s).

Minimum Standards for Valuations - Each licensee should apply the following minimum standards to the valuation of its portfolio securities, and all valuation adjustments should be disclosed in the licensee's valuation report for the affected portfolio concern:

Securities of Private Companies

1. Investment cost is presumed to represent value except as indicated otherwise in these standards.

2. Valuation should be reduced if the portfolio company's performance and potential have significantly deteriorated.

3. Valuation should be adjusted to equate to a subsequent significant equity financing that includes a sophisticated, unrelated new investor. A subsequent significant equity financing that includes substantially the same group of investors as the prior financing should generally not be the basis for an adjustment in valuation.

4. Valuation may be adjusted if the company has been self financing for at least two years and has been cash flow positive for at least one year. The adjustment should be based on P/E ratios, cash flow multiples or other appropriate financial measures of similar companies. The valuation should be discounted by an appropriate percentage for illiquidity, unless liquidity is provided for through redemption or registration rights.

5. Warrants and options should be valued at the excess of the value of the underlying security over the exercise price.

6. Valuation of convertible debt should be adjusted to reflect the value of the underlying security net of the conversion price.

7. Valuation of collateralized securities should include consideration of the value of the underlying collateral, and appropriate adjustments should be made for changes in the value of that collateral.

8. The carrying value of interest bearing securities should not be adjusted for changes in interest rates.

9. Valuation of interest receivables on interest bearing securities should reflect the portfolio concern's financial condition, its payment history and its ability to generate sufficient cash flow to make interest payments. Past due interest should not be valued or converted to a security with carrying value if: (a) interest payments are in default more than six (6) months; (b) the ability of the company to make payments is considered doubtful; and (c) the interest bearing securities do not have a substantial underlying equity value as determined by the above criteria.

Securities of Public Companies

1. Publicly traded securities should be valued at the closing price or bid price except as indicated otherwise in these standards.

2. The valuation of public company securities that are restricted should be discounted appropriately until the securities may be freely traded.

3. When the number of shares of publicly traded securities held by the licensee is substantial in relation to the usual quarterly trading volume, the valuation should be discounted by an appropriate percentage for illiquidity.

Valuation Audit Process

General - The auditing procedures relating to the investment accounts of licensees require greater attention than those of a conventional commercial enterprise because of the relative significance of such assets to the licensee's financial condition.

Auditor's Responsibility - The independent auditor does not act as an appraiser for portfolio security valuations established in good faith by the Board or General Partner(s), is not expected to substitute his or her judgment for that of the licensee's Board or General Partner(s), and does not have the responsibility to determine or estimate the value of a licensee's portfolio securities.

The licensee's Board of Directors or General Partner(s) has (have) the sole responsibility for valuing portfolio securities in good faith.

The independent auditor, however, does have the responsibility to examine, exercise appropriate due diligence and report on the reasonableness and adequacy of the methods, procedures, internal controls and documentation used by the licensee's Board or General Partner(s) in determining the fair value of portfolio securities.

Audit Procedure

1. AICPA Audit Guide - The audit procedures set forth in the AICPA's Guide for Audits of Investment Companies should be followed in auditing licensee valuations, supplemented by the following additional procedures.

2. Conformity With Policy and Regulations - The auditor should determine whether the valuation methods used conformed with the licensee's stated policy. The auditor should also determine whether the licensee's valuations met the minimum standards for valuation required by the regulations of the Small Business Administration.

3. Valuation Methods - The auditor should determine that relevant factors were considered in selecting the methods for valuation and that the methods used by the licensee to establish fair value were reasonable and prudent in the circumstances relating to the investment portfolio.

4. Internal Procedures - The auditor should determine that the internal procedures and controls used by the licensee to establish valuations were reasonable.

5. Information Basis for Valuations - The auditor should determine that the market factors, financial data and other information used to establish valuations was current, accurate and applicable to individual portfolio companies. Where appropriate, the auditor should test the information used as a basis for valuations. The extent of those tests should be based on the auditor's judgment and his or her study and evaluation of the data and procedures used to establish valuations.

6. Documentation - The auditor should determine that the valuations were adequetly documented and recorded.

Opinions on Valuation in the Independent Auditor's Report

Because most licensee portfolio securities do not have readily ascertainable market values, good faith valuations present a unique reporting situation for the independent auditor.

Consequently, the auditor has the option to issue an opinion in one of the following forms:

1. Unqualified Opinion - If the auditor concludes, based on examination of available evidence, that the process used to establish valuations is reasonable, the documentation is appropriate, and the range of possible values is not significant, he should issue an unqualified opinion on the valuations.

The auditor may also choose to emphasize the inherent uncertainty about the valuations by inserting an informative paragraph in the audit report explaining the lack of definitive market values for the licensee's portfolio securities. An explanatory insert of this kind should not be considered a modification of, or qualification to, the auditor's unqualified opinion.

2. Modified Opinion - If the auditor concludes that the process used to establish valuations is reasonable and the documentation is appropriate, but the range of possible values of the licensee's portfolio securities is significant, the auditor's unqualified opinion should be modified to note the lack of ready market values and to indicate that the significant uncertainty about values could be material to a fair presentation of the value of the licensee's portfolio securities.

3. Qualified Opinions

a. If the auditor's examination discloses that the valuation procedures do not conform with the licensee's policies or SBA's minimum standards for valuations, the auditor should issue a qualified opinion indicating a failure to comply with those policies or standards.

b. If the auditor's examination discloses that the valuations are unreasonable or that the underlying documentation does not support the valuations, the auditor should issue a qualified opinion indicating a failure to conform with generally accepted accounting principles.

Notice to SBA - If a qualified opinion on valuations is issued, the auditor shall simultaneously notify SBA of the opinion, including with the notice a statement explaining the reasons for the qualified opinion and appropriate supporting documentation.

INTERNATIONAL TRADE COUNCIL
3114 CIRCLE HILL ROAD
ALEXANDRIA, VIRGINIA 22305, USA
(703) 684-1980 • (703) 548-1234 • FAX (703) 548-6216

Statement of Dr. Peter Nelsen, President
International Trade Council &
Anthony Greenberg, Director of
Legislative Affairs,
International Development Institute
submitted to the
The U.S. House of Representatives,
Committee on Small Business
on the subject of the
Small Business Committee to Investigate
SBIC Problems
October 2, 1990

Mr. Chairman and members of the Committee, we thank you for this opportunity to submit testimony before the House Committee on Small Business.

I am Dr. Peter Nelsen, an economist and President of the International Trade Council (ITC). ITC is a trade association dedicated to the expansion of free trade world-wide. The companies we represent are U.S. based.

I. THE PROBLEM

The Small Business Investment Company (SBIC) program was begun for the purpose of aiding new businesses in starting up. In order to accomplish this task, the SBIC's offered loans to the entrepreneur in order either to finance an improvement or begin a new project.

The Committee on Small Business has identified a basic problem with the SBIC's. The problem is that SBIC's have experienced major fiscal revenue losses. Because of these losses, the Small Business Committee is considering giving the SBIC portfolios to certified public accountants as "an effective means of auditing SBIC's."

We believe that this solution will only worsen matters for the SBIC's. In order for the SBIC's to be "reinvigorated," major changes in the methods of SBIC loan financing are needed. The initial change must be in the methods by which SBIC decides who can be eligible for a loan.

II. LOAN CERTIFICATION

In order to better insure that a business venture will succeed, it is important for the SBIC's to have some form of advance warning on the likelihood of success of a small business. Currently, the SBIC's have no such method of pre-approval. This pre-screening can be done easily. In order for a potential borrower to receive loan funds, he would first have to pass a peer review. Essentially, a peer review would be a review by other members of the industry in which the potential borrower is operating or a specialized industry consultant, a college or university department which deals with the subject area. The SBIC would then decide based on this review whether the idea is worth funding. In this manner, the SBIC could have a better guarantee that a given idea will succeed and loan defaults would be reduced.

III. LOAN STRUCTURE

Aside from changes in the methods which SBIC uses in ascertaining the viability of a business, SBIC's also must change the way it finances the new businesses. The problem is that the SBIC's often want too much in return for their loans. The SBIC's regularly demand a high interest rate of between eighteen and twenty percent for each loan. This means that an emerging business is strapped right from the start with higher cost of capital thus reducing their competitiveness.

Besides putting new businesses in an interest choke-hold, the SBIC's also generally demand a substantial share of the ownership of the company. The entrepreneur, thus, becomes little more than an employee of the SBIC's. No entrepreneur wants to be an employee. Moreover, SBIC's have few technical experts on board to assist the development of a new project. These high demands sap an entrepreneur of the initiative and desire to expand and are a detriment to small business expansion and the aim of expanding the U.S. economy.

Instead, the SBA should cap SBIC interest rates in order to encourage small businesses to use SBIC's and in order not to strangle a small business in its infancy. Secondly, rather than controlling the operations of a small business, the SBIC should be as a limited partner only, if it insists on an equity share. In this way, the SBIC can keep watch on the operations of the business in a detached manner that will allow the entrepreneur to make business decisions for himself. The entrepreneur should begin to repay the debt after the start-up period as indicated in the business plan. By this method, the funds borrowed can be used for business development and not set aside to make payments on the loan before an income stream is established.

III. CONCLUSION

Our suggested plan would provide financing for the entrepreneur, increased security for the Government and oversight for the SBIC's, thus lowering his risk and minimizing the default rate of the SBA program.

Putting SBIC's under the oversight of accountants would reduce entrepreneurship in the United States. Accountants are usually not experts in issues concerning individual industries. They are not entrepreneurial by nature. They are generally not in a position to evaluate the potential of success of a small business because they are not familiar with specialized industrial concerns. For this reason, it is important to rely on the opinions of experts in the industry by means of the peer review as suggested above. We strongly discourage the use of accountants for any purpose but accounting.

The important issue, however, is not microeconomic, but macroeconomic. It is important for our lawmakers to remember that even our suggested system will not guarantee success one hundred percent of the time. No system can guarantee that level of success. But overall, even if one out of every four businesses fail, under this system, in the aggregate, many new businesses are still being added. The additional corporate and individual taxes derived would far exceed the loss of the few failures. These additions can only benefit our economy, whose lagging productivity levels have been the cause of so much concern.

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